NISM – Series – V – A :
Mutual Fund Distributors Certification Examination – October 2013

Nurturing Talent for Success

NJ GURUKUL

Examination Objectives

1. Know the basics of mutual funds, their role and structure, different kinds of mutual fund schemes and their features.
2. Understand how mutual funds are distributed in the market-place, how schemes are to be evaluated, and how suitable products and services can be recommended to investors and prospective investors in the market.
3. Get oriented to the legalities, accounting, valuation and taxation aspects underlying mutual funds and their distribution.
4. Get acquainted with financial planning as an approach to investing in mutual funds, and an aid for advisors to develop long term relationships with their clients.

Assessment Structure

- The examination consists of 100 questions of 1 mark each.
- Should be completed in 2 hours.
- **The passing score on the examination is 50%.**
- **There shall be NO negative marking. So, attempt all questions.**

Schedule

- **Day 1 :**
  - » Chapter 1
  - » Chapter 2
  - » Chapter 3
  - » Chapter 4
  - » Chapter 5
  - » Chapter 7
- **Day 2 :**
  - » Chapter 8
  - » Chapter 6
  - » Chapter 9
  - » Chapter 10
  - » Chapter 11
  - » Chapter 12

CHAPTER 1

CONCEPT AND ROLE OF A MUTUAL FUND

Concept of Mutual Fund

- Mutual fund is a vehicle to mobilize moneys from investors, to invest in different markets and securities, in line with the investment objectives agreed upon, between the mutual fund and the investors.
- In other words, through investment in a mutual fund, a small investor can avail of professional fund management services offered by an asset management company.
- **The ownership of the fund is thus joint or mutual, the fund belongs to all investors.**

Role of Mutual Funds

- **Primary Role** is to assist investors in earning an income or building their wealth.
- It is possible for mutual funds to structure a scheme for any kind of **investment objective.**

Ultimate Benefit

- The money that is raised from investors, ultimately benefits governments, companies or other entities, directly or indirectly, to raise moneys to invest in various projects or pay for various expenses.
- Mutual funds can also act as a market stabilizer and therefore viewed as a key participant in the capital market of any economy. .
- **Important :** As a large investor, the mutual funds can keep a check on the operations of the investee company, and their corporate governance and ethical standards.
- Through funds raised by such financing economic cycle will see a growth, resulting into employment in the economy as well as within the intermediaries of Mutual Fund industry itself and growth in revenue of Government also through taxes.

What Is Mutual Fund?

- Mutual funds seek to mobilize money from all possible investors. Various investors have different investment preferences.
- **In order to accommodate these preferences, mutual funds mobilize different pools of money. Each such pool of money is called a '*Mutual Fund Scheme*'** as mentioned before.
- Every scheme has a pre-announced investment objective. **When investors invest in a mutual fund scheme, they are effectively buying into its investment objective.** The objective can be to invest in Equity, Debt, Gold or it can be to invest in all of them together through various hybrid schemes.

Operations Of Mutual Fund

- Against the investment, Mutual Fund allots 'Units' to the investor.
- Under the law, every unit has a face value of Rs. 10. (However, older schemes in the market may have a different face value).
- **No. of Units * Face Value (Rs. 10) = Unit Capital**
- **Returns in Mutual funds can be earned through**
  - » Interest and
  - » Dividends on the investments it holds. Moreover,
  - » Capital Gains / Capital Losses when it sells investments.

Operations Of Mutual Fund - AUM

- The relative size of mutual fund companies is assessed by their **Assets Under Management (AUM)**.
- When a scheme is first launched, assets under management would be the amount mobilized from investors. Thereafter, if the scheme has a positive profitability metric, its AUM goes up; a negative profitability metric will pull it down.
- Further, if the scheme is open ended contributions from investors boost the AUM. Conversely, if the scheme pays any money to the investors, either as dividend or as consideration for buying back the units of investors, the AUM falls.
- **The AUM thus captures the impact of the profitability metric and the flow of unit-holder money to or from the scheme.**

Operations Of Mutual Fund

- It is absolutely possible that the market value of the securities in the portfolio is absolutely different than its purchase price. Difference between the Purchase Price and Current Market Price of the securities is called **'Valuation Gains / Valuation Losses'** (When the securities are not sold – They are still lying in the portfolio).
- The true worth of a unit of the scheme is otherwise called ***'Net Asset Value (NAV) of the scheme'***.
- When a scheme is first made available for investment, it is called a ***'New Fund Offer' (NFO)***.

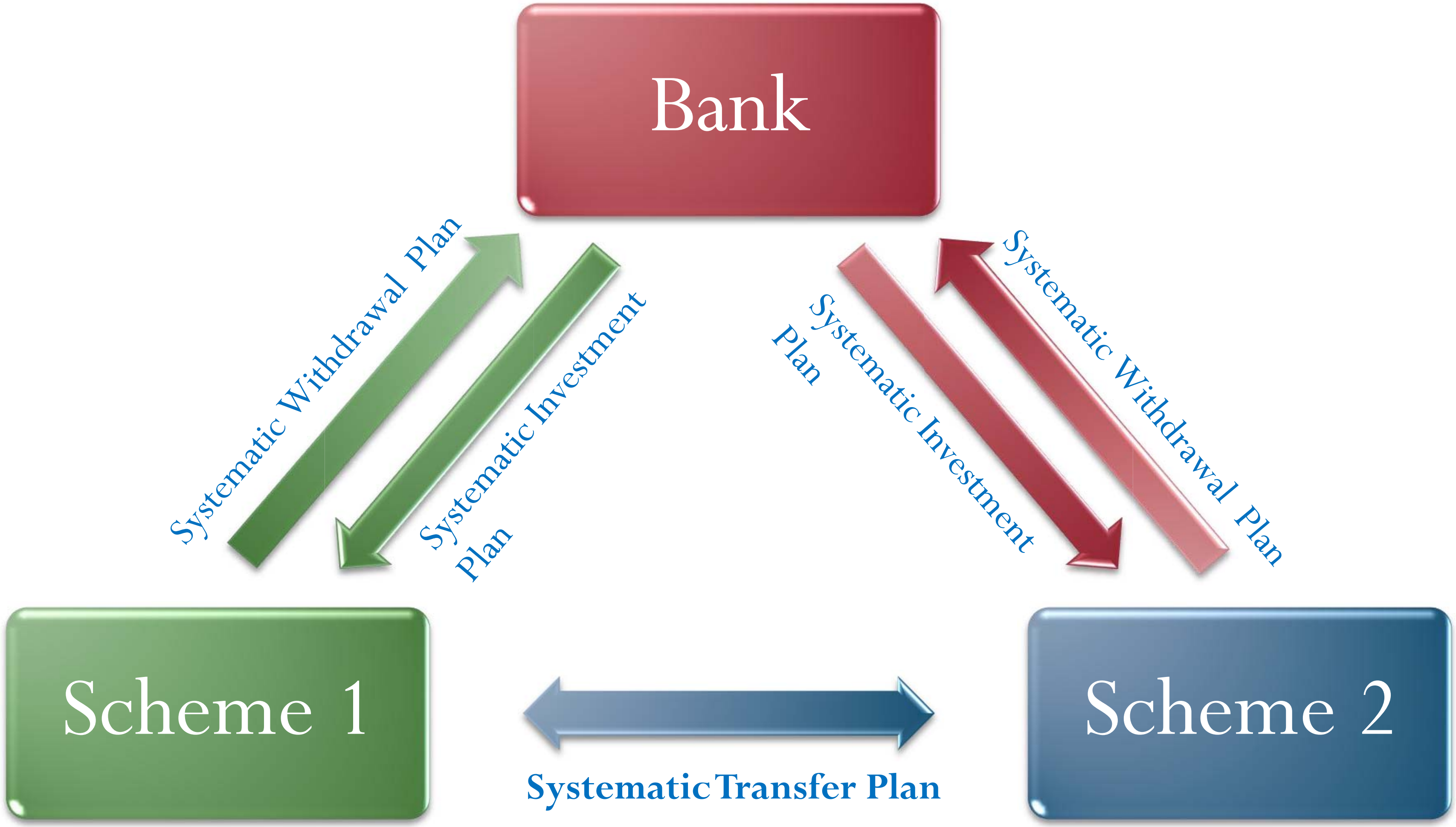
Important Statements

- **The ownership is in the hands of the investors (Unit holders) who have pooled in their funds so ownership is 'Joint and Mutual'.**
- The price at which the units are bought and sold from the AMC is called 'NAV' (loads are not considered) and it changes every day.
- **In India, Mutual Funds are constituted as TRUST.**
- **Risk can be divided in two : i. Standard Risk ii. Specific Risk. Standard Risk Factors** are common for all Mutual Funds.
- Mutual Funds are not allowed to invest in **'Art'** in India.

Advantages

- Portfolio Diversification
- Reduction In Risk
- Professional Management
- Economies Of Scale
- Liquidity
- Tax Deferral – Payment of Tax at the time of sale only.
- Tax Benefits – ELSS and RGESS
- Convenience And Flexibility
- Regulatory Comfort
- Systematic Approach To Investment – SIP, STP and SWP

SIP, STP And SWP



SIP, STP And SWP

- **Systematic Investment Plan (SIP) :**
  - SIP is an approach where the investor invests constant amounts at regular intervals.
  - A benefit of such an approach is, it **gives Rupee Cost Averaging.**
  - Through an SIP, the investor does not end up in the unfortunate position of acquiring all the units in a market peak.
  - Mutual funds make it convenient for investors to lock into SIPs by investing through Post-Dated Cheques (PDCs), ECS or standing instructions.

SIP, STP And SWP

- **Systematic Withdrawal Plan (SWP) :**
  - Just as investors do not want to buy all their units at a market peak, they do not want all their units redeemed in a market trough.
  - Investors can therefore opt for the safer route of offering for re-purchase, a constant value against units.
  - Mutual funds make it convenient for investors to manage their SWPs by indicating the amount, periodicity (generally, monthly) and period for their SWP.
  - Accordingly, the mutual fund will re-purchase the appropriate number of units of the unit-holder, without the formality of having to give a re-purchase instruction for each transaction.
  - Some schemes even offer the facility of transferring only the appreciation or the dividend.

SIP, STP And SWP

- **Systematic Transfer Plan (STP) :**
  - This is a variation of SWP.
  - In a STP, the amount that is withdrawn from a scheme is re-invested in some other scheme of the same mutual fund.
  - Thus, it operates as a SWP from the first scheme, and a SIP into the second scheme.
  - **STP is a combination of SWP + SIP**
  - The Unit-holder can avoid two sets of paper work (Sale and Re-purchase) for every period.
  - Thus, STP offered by mutual funds is a cost-effective and convenient facility.

Disadvantages

- Lack of Customisation
- Choice Overload
- Issue relating to management of portfolio of Mutual Funds
- No control over costs – However, SEBI has imposed certain limits on the expenses that can be charged to any scheme.

Classification of MF

Basic Features	Open Ended Funds	Close Ended Funds
Purchase / Additional Purchase	Can be done any time, Even after NFO.	Can be done during NFO only. Post NFO, additional purchase can be done **only** through stock exchanges.
Redemption	Done any time	Only at the maturity. However, Post NFO, transactions can be done through Stock Exchanges. (It is mandatory for them to be listed on stock exchange – Price at stock exchanges can be different than NAV.)
No of Units	Variable	Fixed
Unit Capital	Variable	Fixed

SEBI has abolished entry load since 1stAugust 2009 from all mutual fund schemes. Prior to that date, the purchase transactions were happening at a price linked to the NAV.

Classification of MF

- **<u>Interval Funds</u> :**
  - Basically close ended funds, but has features of Open ended funds also.
  - This close ended fund opens at certain intervals during the maturity term.
  - During these intervals, it behaves like open ended funds. So, any sought of transactions can be done with AMC. After the closure of this interval, it becomes close ended till next interval. **They have to be listed mandatorily on the stock exchanges.**
  - Minimum duration of an interval period in an interval scheme/plan is 15 days.
  - The specified transaction period will be of minimum 2 working days, as per revised SEBI Regulations.

Classification of MF

Basic Features	Active Funds	Passive Funds
Objective	Get higher returns, beat the market	Mirror the returns of the market
Fund Manager's Activities	Very active, chooses securities in the portfolios and churn the portfolio if required to do so to get better returns	Does not have to be active as he will take only those securities which are part of the benchmark whose returns are to be mirrored and no churning required as market returns are not to be beaten.
Expense Ratio	High	Low
Examples	Diversified Equity or Debt Scheme	Index Funds

Classification of MF – As Per Investment Objective

- **Equity Schemes :**
  - A scheme might have an investment objective to invest largely in equity shares and equity-related investments like convertible debentures.
  - The investment objective of such funds is to seek capital appreciation through investment in this growth asset.
- **Debt Funds :** Schemes with an investment objective that limits them to investments in debt securities - Government or Corporate.
- **Hybrid funds :** have an investment charter that provides for investment in both Debt, Equity and even in Gold along with previous ones.

Types Of Equity Funds

- **Sector Funds** invests in only a **specific sector**. It is the highest risk scheme in the whole universe of MF.
- **Thematic Funds** invest in line with an investment theme. **A Thematic Fund is more broad based than a sector fund, but has narrower exposure than a diversified fund.**
- **Diversified Equity Fund** is a category of funds that invest in a diverse mix of securities that cut across sectors.

Types Of Equity Funds

- **Equity Income / Dividend Yield Schemes** invest in securities whose shares fluctuate less, and the **dividend represents a larger proportion of the returns on those shares.**
- **Arbitrage Funds** take contrary positions in different markets / securities, such that the risk is neutralized, but a return is earned.
  - Most of them take contrary positions between the equity market and the futures and options market.
  - **The objective is to take advantage of mispricing of securities between two markets.**
  - **They are taxed as Equity Schemes.**

Types Of Equity Funds

- **Equity Linked Saving Schemes [ELSS] :**
  - Offers Tax Benefit on investments up to Rs. 1,00,000
  - 3 year lock in period from **each installment**
  - Maximum investment is in Equities only
  - Tax benefit at the time of investment u/s 80 (C) and redemption value does not attract Capital Gain Tax.

Types Of Debt Funds

- **Gilt Funds** invest in only treasury bills and government securities, which **do not have a credit risk.**
- **Diversified Debt Funds** on the other hand, invest in a mix of government and non-government debt securities. **They are also known as Income Funds.**
- **Junk Bond** schemes or high yield bond schemes invest in companies that are of poor credit quality (Credit Rating lower than Investment Grade).
- **Fixed Maturity** plans are a kind of debt fund where the investment portfolio is closely aligned to the maturity of the scheme. Being close-ended schemes, they do not accept money post-NFO. **Returns can be reasonably predicted at the time of investment only. Good alternative to Fixed Deposits with compromise in liquidity.**

Types Of Debt Funds

- **Floating Rate Funds** invest largely in floating rate debt securities i.e. debt securities where the interest rate payable by the issuer changes in line with the market. **The NAVs of such schemes fluctuate lesser than debt funds that invest more in debt securities offering a fixed rate of interest.**
- **Liquid Schemes or Money Market Schemes** are a variant of debt schemes that invest only in debt securities where the moneys will be repaid within **60-days**. **The least risky scheme in the whole universe of mutual funds.**

Investment Options In Gold Through MF

- **Gold Exchange Traded Fund (Gold ETF)** is a fund that invests in gold, gold-related securities or gold deposit schemes of banks. **The NAV of such funds moves in line with gold prices in the market.**
- **Gold Sector Fund** will invest in shares of companies engaged in gold mining and processing. Therefore, **NAV of these funds do not closely mirror gold prices.**
- **It is important to understand that unlike Gold sector fund, Gold ETF does not invest in equity shares of companies involved in Gold related businesses including gold mining.**

Characteristics Of Exchange Traded Funds

- Exchange Traded funds (ETF) are open-ended funds, whose units are traded in a stock exchange.
- In order to facilitate such transactions in the stock market, the mutual fund appoints some intermediaries as **Market Makers**, whose job is to offer a price quote for buying and selling units at all times.
- When investor buys from the market, their money would be due to the market maker against which the market maker can offer the units to the investors.
- In a regular open-ended mutual fund, all the transactions by investors on a day happen at a single price. **A key benefit of an ETF is that investors can buy and sell their units in the stock exchange, at various prices during the day that closely track the market at that time.**

Types of Hybrid Funds

- **Monthly Income Plan** seeks to declare a dividend every month.
  - It therefore invests largely in debt securities. However, a small percentage is invested in equity shares to improve the scheme's yield.
  - **It does not guarantee any monthly income.**
- **Balanced Fund :** It gives an investor exposure to both equity and debt simultaneously in one portfolio.
  - The balanced funds can have fixed or flexible allocation between equity and debt.
- **Now, Hybrid Mutual Funds are also allowed to invest in Gold.**

Types of Hybrid Funds

- **Capital Protected Schemes** are close-ended schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market.
  - » The amount is invested in **Zero Coupon Government Securities, maturity of which is aliened with the maturity of these schemes,** in such a way that at the maturity the investor will get at least the capital back. Rest of the money is invested to get higher returns.
  - » If investment is done in corporate debt securities also, they will be called **Capital Protection Oriented Schemes.**
  - » Some of these funds are also launched as **Asset Allocation Funds. These schemes are not different from those under the Hybrid category.**

Other Funds

- **Real Estate Funds** take exposure to real estate. Such funds make it possible for small investors to take exposure to real estate as an asset class. Although permitted by law, **real estate mutual funds are yet to hit the market in India.**
- **Commodity Funds**
  - In India, mutual fund schemes **are not** permitted to invest in commodities, **other than Gold**.
  - Therefore, the commodity funds in the market are in the nature of Commodity Sector Funds, i.e. funds that invest in shares of companies that are into commodities.

Other Funds

- **International Funds** are funds that invest outside the country.
  - A mutual fund may offer a scheme to investors in India, with an investment objective to invest abroad.
  - **Option I**
    - Domestic AMC - Feeder Fund
    - Foreign AMC - Host Fund
  - **Option II**
    - Setting up own infrastructure to function in other country.
  - **Risks**
    - Asset Performance Risk
    - Currency Risk

Other Funds

- **Fund of Funds**
  - Feeder Fund in International fund is an example of Fund of Funds.
  - Fund of Fund can be domestic and international also.

Current MF Industry

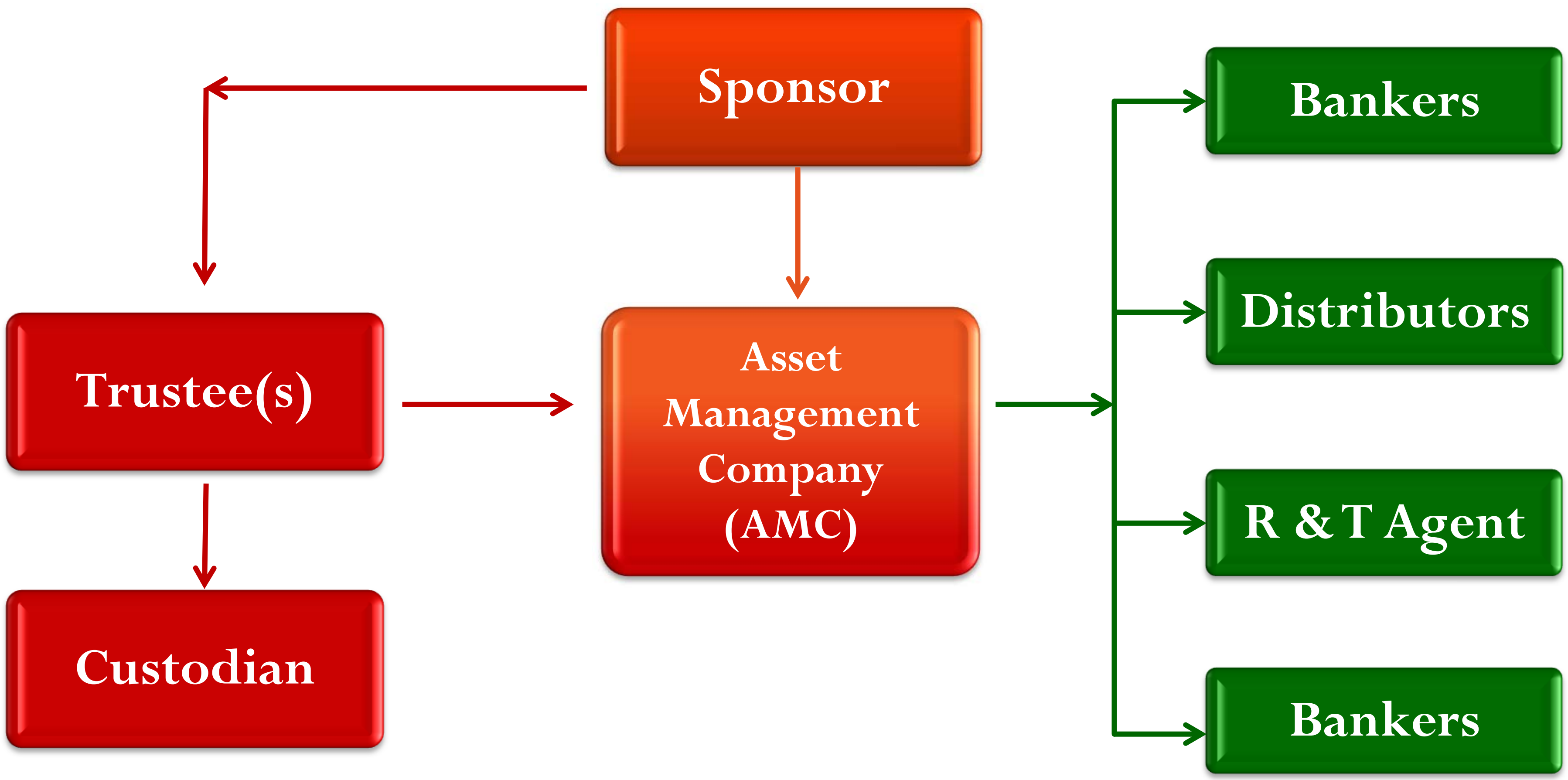
- AUM of the industry, as of July 31, 2013 has touched Rs 760,833 crore from 1172 schemes offered by 44 mutual funds.

End of the chapter…

CHAPTER 2

FUND STRUCTURE AND CONSTITUENTS

Structure


Sponsor
Trustee(s)
Asset Management Company (AMC)
Custodian
Bankers
Distributors
R & T Agent
Bankers

Structure - Example

Sponsor :
State Bank of India

Trustee :
SBI Mutual Fund Trustee Company Private Limited

AMC :
SBI Funds Management Private Limited

Custodians :

- HDFC Bank Limited, Mumbai
- CITI BANK N.A., Mumbai
- Stock Holding Corporation of India Ltd., Mumbai
- Bank of Nova Scotia (custodian for Gold)

Bankers

Distributors

R & T Agent :
Computer Age Management Services Pvt. Ltd (CAMS)

Bankers

Sponsor

- The application to SEBI for registration of a mutual fund is made by the sponsor/s.
- **Eligibility of a Sponsor :**
  - Sponsor should be carrying on business in financial services for 5 years.
  - Sponsor should have positive net worth (share capital plus reserves minus accumulated losses) for each of those 5 years.
  - Latest net worth should be more than the amount that the sponsor contributes to the capital of the AMC.
  - The sponsor should have earned profits, after providing for depreciation and interest, in three of the previous five years, including the latest year.
  - **The sponsor needs to have a minimum 40% share holding in the capital of the AMC.**

Trust

- In order to perform the trusteeship role, either individuals may be appointed as trustees or a Trustee company may be **appointed by the sponsors only**.
- **Prior approval of SEBI needs to be taken, before a person is appointed as Trustee.**
- They have a critical role in ensuring that the mutual fund complies with all the regulations, and **protects the interests of the unit-holders**.
- **Eligibility**
  - Every trustee has to be a person of ability, integrity and standing.
  - A person who is guilty of moral turpitude cannot be appointed trustee.
  - A person convicted of any economic offence or violation of any securities laws cannot be appointed as trustee.

Trust

- The sponsor will have to appoint at least 4 trustees.
- If a trustee company has been appointed, then that company would need to have at least 4 directors on the Board.
- At least two-thirds (2/3) of the trustees / directors on the Board of the trustee company, would need to be ***independent trustees i.e. not associated with the sponsor in any way.***
- **The agreement between Sponsor(s) and Trustees is called 'Trust Deed'.**
- **All the schemes belong to trustees and all major decisions are taken by trustee.**

Asset Management Company

- Day to day operations of asset management is handled by the AMC.
- **The AMC is appointed by the sponsor or the Trustees.**
- **Prior approval of the trustees is required, before a person is appointed as director on the board of the AMC.**
- The AMC has ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of the SEBI regulations and the trust deed.
- **At least 50% of the directors should be independent directors** i.e. not associate of or associated with the sponsor or any of its subsidiaries or the trustees.
- **The AMC needs to have a minimum net worth of Rs. 10 crore.**
- **The agreement between the Trustees and the AMC is known as 'Investment Management Agreement'.**

Asset Management Company

- An AMC cannot invest in its own schemes, unless the intention to invest is disclosed in the Offer Document. Further, the AMC cannot charge any fees for its own investment in any of the schemes managed by itself.
- **The appointment of an AMC can be terminated by majority of the trustees, or by 75% of the Unit-holders.** However, any change in the AMC is subject to prior approval of SEBI and the Unit-holders.

Other Entities In AMC

- **Chief Investment Officer (CIO)** is responsible for overall investments of the fund. Fund managers assist the CIO.
  - As per SEBI regulations, every scheme requires a fund manager, though the same fund manager may manage multiple schemes.
- **Securities Analysts** support the fund managers through their research inputs.
- **Securities Dealers** help in putting the transactions through in the market.
- **Chief Marketing Officer (CMO)** is responsible for mobilizing money under the various schemes.
- **Chief Operations Officer (COO)** handles all operational issues.
- **Compliance Officer** needs to ensure all the legal compliances. In Offer Documents of new issues, he signs a **due-diligence certificate** to the effect that all regulations have been complied with.

Other Service Providers - Custodians

- The custodian has custody of the assets of the fund.
- **The Custodian is appointed by the mutual fund (Trustees).**
- All custodians need to register with SEBI.
- The custodian settles all the transactions on behalf of the mutual fund schemes.
- A **'Custodial Agreement'** is entered into between the **trustees and the custodian.**
- **More than 50% of the custodian or directors of the custodians should be independent from the sponsors. So, the custodian and sponsor cannot be the same entity.**

Other Service Providers – R & T Agent

- All RTAs need to register with SEBI.
- **The appointment of RTA is done by the AMC.**
- The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a Registrar & Transfer Agent (RTA).
- So, it is not compulsory to appoint a RTA. **The AMC can choose to handle this activity in-house.**
- Examples : CAMS and Karvy

Other Service Providers – Auditors

- Auditors are responsible for the audit of accounts.
- Accounts of the schemes need to be maintained independent of the accounts of the AMC.
- **The auditor appointed to audit the scheme accounts needs to be different from the auditor of the AMC.**
- **While the scheme auditor is appointed by the Trustees, the AMC auditor is appointed by the AMC.**

Other Service Providers

- **Fund Accountant** performs the role of calculating the NAV.
  - There is no need for a registration with SEBI to perform this function.
  - **The AMC can either handle this activity in-house or can outsource it.**
- **Distributors**
  - Distributors need to pass the prescribed certification test, and register with AMFI.

Other Service Providers

- **Collecting Bankers**
  - These bank accounts are maintained with collection bankers who are **appointed by the AMC.**
- **KYC Registration Agencies**
  - SEBI has mandated a **unified KYC for the securities market** through KYC Registration Agencies registered with SEBI.
  - In-Person Verification (IPV) by a SEBI-registered intermediary is compulsory for all investors.
  - Distributors who have a valid NISM-Series-V-A: Mutual Fund Distributors certificate and a valid ARN can carry out the In-person verification if they have completed the KYD process.

Important Statements

- The structure of mutual funds in India is governed by SEBI(Mutual Fund) Regulations, 1996.
- Sponsor is the entity who wants to open Mutual Fund. **Sponsor is like a Promoter of a company.** Sponsor can be one or more.
- The fund sponsor acts as the **Settler of trust.** A sponsor of a mutual fund can act as **the distributor of the Mutual fund but cannot act as Trustee and/or Custodian of the Mutual Fund.**
- **In India Mutual Fund is established as a Trust.** They are governed by the Indian Trusts Act, 1882.
- Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund. That is why it is said that **"Trust holds investor's money in fiduciary capacity"**.
- It is mandatory to have a three tier structure of Sponsor-Trustee-Asset Management Company.

End of the chapter…

CHAPTER 3

LEGAL AND REGULATORY ENVIRONMENT

Regulator - SEBI

- SEBI is the regulatory authority for securities markets in India.
- It regulates, among other entities, mutual funds, depositories, custodians and registrars & transfer agents in the country.
- **Mutual Funds are regulated by SEBI ONLY but mutual funds need to comply with RBI's regulations** regarding investment in the money market, investments outside the country, investments from people other than Indians resident in India, remittances (inward and outward) of foreign currency etc.
- Mutual Funds need to comply with the rules of the exchanges with which they choose to have a business relationship.
- **Anyone who is aggrieved by a ruling of SEBI, can file an appeal with the Securities Appellate Tribunal (SAT).**

Self Regulatory Organizations (SRO)

- Regulators lay down the broad policy framework, and leave the micro-regulation to the SRO.
- Prime responsibility of SRO is to regulate their own members.
- **Examples : Institute of Chartered Accountants of India (ICAI), NSE, BSE**
- **AMFI is not an SRO.**

AMFI Objectives

- AMCs in India are members of AMFI.
- To define and maintain high professional and ethical standards.
- To recommend and promote best business practices and code of conduct.
- To interact with the SEBI and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the Government, Reserve Bank of India and other bodies on all matters related to MF industry.
- To develop a cadre of well-trained Agent distributors and to implement a programme of training and certification.
- To undertake nationwide investor awareness programme.
- To disseminate information on Mutual Fund Industry and to undertake studies and research directly.

AMFI's Code Of Conduct For Intermediaries Of Mutual Funds

- AMFI has framed a set of guidelines and code of conduct for intermediaries, consisting of individual agents, brokers, distribution houses and banks.
- In the event of breach of the Code of Conduct by an intermediary, the following sequence of steps is provided for:
  - » Write to the intermediary (enclosing copies of the complaint and other documentary evidence) and ask for an explanation within 3 weeks.
  - » In case explanation is not received within 3 weeks, or if the explanation is not satisfactory, AMFI will issue a warning letter indicating that any subsequent violation will result in cancellation of AMFI registration.
  - » **If there is a proved second violation by the intermediary, the registration will be cancelled, and intimation sent to all AMCs.**
- The intermediary has a right of appeal to AMFI.

*** The details are given on Appendix 2 on page no. 59. Go through it at least once.**

Guidelines For Circulation Of Unauthenticated News

- Employees/ temporary staff/voluntary workers etc. should not encourage or circulate rumors or unverified information obtained from client, industry, any trade or any other sources without verification and
- Any market related news received by them either in their official mail/personal mail/blog or in any other manner, should be forwarded only after the approval of concerned Intermediary's Compliance Officer..
- Access to Blogs/Chat forums/Messenger sites etc. should either be restricted under supervision or access should not be allowed. Logs for any usage of such Blogs/Chat forums/Messenger sites (called by any nomenclature) have to be treated as records and the same should be maintained.
- If an employee fails to comply with the regulations, then he/she shall be liable for action. The Compliance Officer shall also be held liable for breach of duty in this regard.

Due Diligence Process By AMCs For Distributors Of Mutual Funds

- SEBI has mandated AMCs to put in place a due diligence process to regulate distributors who qualify any one of the following criteria:

  a. **Multiple point presence (More than 20 locations)**

  b. **AUM raised over Rs.100 crore across industry in the non-institutional category but including high net worth individuals (HNIs)**

  c. **Commission received of over Rs. 1 Crore p.a. across industry**

  d. **Commission received of over Rs. 50 Lakhs from a single mutual fund**

- Please refer to factors for the same on page no. 44.

Major Terminologies

- **Investment Objective :** It defines asset class in which money will be invested.
  - For example, the investment objective of a **Diversified Equity Scheme** might read as follows:

    "To generate capital appreciation from a portfolio of predominantly equity related securities."
  - The investment objective of a **Diversified Debt Scheme** could be:

    "To generate income by investing predominantly in a wide range of debt and money market securities."
  - A **Balanced Scheme** would have an investment objective like:

    "To achieve growth by investing in equity and equity related investments, balanced with income generation by investing in debt and money market instruments."

Major Terminologies

- **Investment Policy :**
  - Defines **which kind and how many** of papers or stocks the fund can buy and it can buy
  - For example:

1. **"The portfolio will generally comprise of equity and equity related instruments of around 30 companies, which may go upto 39 companies"; or**
2. **"Investment will be predominantly in mid-cap stocks"; or**
3. **"More than 50% will be invested in equity and equity related securities; the rest would be in debt and money market securities"**

Major Terminologies

- **Investment Strategy :**
  - It suggests like… should exposure of any sector/stock be increased, should cash be increased Investment strategy goes into much details and may change every day.
- **While the investment objective and investment policy are part of the offer document, investment strategy is decided more frequently.** Many AMCs have a practice, where every morning, the senior management (CEO, CIO, and Fund Managers) discuss the need for any change in their investment strategy.

Investors' Rights & Obligations

1. Service Standards Mandated for a Mutual Fund towards its Investors

- Schemes other than ELSS and RGESS can remain open for subscription for a maximum of **Fifteen (15) days**.
- In the case of RGESS schemes, the offering period shall be not be more than **thirty (30) days.**
- Schemes, other than ELSS and RGESS, need to **allot units or refund** moneys within **5 business days** of closure of the NFO. **RGESS** schemes are given a period of **15 days** from closure of the NFO to make the refunds.
- If minimum amount required to operate the scheme is not collected from NFO then the money has to be returned in **SIX Weeks.** **In the event of delays in refunds, dividend warrants or redemption / repurchase cheques, investors need to be paid interest at the rate of 15% p.a. for the period of the delay.** **This interest cannot be charged to the scheme.**
- Open-ended schemes, other than ELSS, have to **re-open** for ongoing sale / re-purchase within **5 business days of allotment**.

Investors' Rights & Obligations

- **Statement of accounts are to be sent to investors as follows:**
- In the case of NFO - Within **5 business days** of closure of the NFO (15 days for RGESS)
- Post-NFO investment - **Within 10 working days** of the investment
- **In the case of SIP / STP / SWP**
  - Initial transaction - **within 10 working days**
  - Ongoing - Once **every calendar quarter** (March, June, September, December) **within 10 working** days of the end of the quarter
- On specific request - **Within 5 working days without any cost.**

Investors' Rights & Obligations

- **Statement of accounts are to be sent to investors as follows:**
- Statement of Account shall also be sent to dormant investors i.e. investors who have not transacted during the previous 6 months.
- If mandated by the investor, soft copy shall be e-mailed to investor every month.
- If a Unit-holder asks Unit Certificates, the AMC is bound to issue the Unit Certificate within **5 working days** of receipt of request (**15 days for RGESS**).
- **Dividend warrants** have to be dispatched to investors within **30 days of declaration of the dividend.**
- Redemption / re-purchase cheques would need to be dispatched to investors within **10 working days** from the date of receipt of transaction request.

Investors' Rights & Obligations

- NAV has to be published daily, in at least 2 daily newspapers having circulation all over India.
- NAV and re-purchase price are to be updated in the website of AMFI and the mutual fund
  - In the case of other schemes, by **9 pm the same day**
  - In the case of Fund of Funds, by **10 am the following day**
- The investor/s can appoint up to **3 nominees,** who will be entitled to the Units in the event of the demise of the investor/s.
- The investor can also pledge the units.

Investors' Rights & Obligations

2. **Other Rights of Investors**

- Investors can choose to change their distributor or go direct without insisting on any kind of **No Objection Certificate** from the existing distributor.
- Investors can choose to hold the Units in dematerialized form.
- **In the case of unit-holding in demat form, the demat statement given by the Depository Participant would be treated as compliance with the requirement of Statement of Account.**
- Complete statement of the scheme portfolio and the half-yearly unaudited financial results, within 1 month from the close of each half year in one National English daily, and one newspaper published in the language of the region where the head office of the mutual fund is situated.
- Scheme-wise Annual Report or an abridged summary has to be mailed to all unit-holders within 6 months of the close of the financial year. The Annual Report of the AMC has to be displayed on the website of the mutual fund.

Investors' Rights & Obligations

2. **Other Rights of Investors**

- Debt-oriented, close-ended / interval, schemes /plans need to disclose their portfolio in their website every month, by the 3rd working day of the succeeding month.
- The mutual fund has to report on the number of complaints, the time period in which they were resolved, and if not resolved, for how long they remain unresolved.
- **Pending investor complaints can be a ground for SEBI to refuse permission to the AMC to launch new schemes.**

Investors' Rights & Obligations

2. **Other Rights of Investors**

- **The Trustees / AMC cannot make any change in the fundamental attributes of a scheme, unless**

    1. A written communication about the proposed change is sent to each Unit-holder, and an advertisement is issued in an English daily Newspaper having nationwide circulation, and in a newspaper published in the language of the region where the head office of the mutual fund is located.
    2. Dissenting unit-holders are given the option to exit at the prevailing Net Asset Value, without any exit load. **This exit window has to be open for at least 30 days.**

- The merger or consolidation of two or more schemes has so far been considered as a change in the fundamental attributes of the schemes.

Investors' Rights & Obligations - Important

2. Other Rights of Investors

- The appointment of the **AMC** for a mutual fund can be **terminated** by a **majority of the trustees or by 75% of the Unit-holders** (in practice, Unit-holding) of the Scheme.
- **75% of the Unit-holders (in practice, Unit-holding) can pass a resolution to wind-up a scheme.**
- **The Trustees are bound to obtain consent of the Unit-holders:**
  - » Whenever required to do so by SEBI, in the interest of the Unit-holders
  - » Whenever required to do so by 75% of the Unit-holders (in practice, Unit-holding) of the scheme
  - » When the trustees decide to wind-up or prematurely redeem the scheme

Limitation of Rights of Unit-holders

- If an investor feels that the trustees have not fulfilled their obligations, then he can file a suit against the trustees for breach of trust but **cannot sue the Trust.**
- The principle of caveat emptor (let the buyer beware) applies to mutual fund investments.
  - » No legal protection on the grounds of not being aware.
- **A proposed investor i.e. someone who has not invested in the scheme does not have rights to proceed against the AMC or trustees.**
- **Investors in MF can not get protection under Companies Act, 1956.**

Unclaimed Amounts

- The mutual fund has to deploy unclaimed dividend and redemption amounts in the money market.
- AMC can recover investment management and advisory fees on management of these unclaimed amounts, at a maximum rate of **0.50% p.a.**
- Recovery of such unclaimed amounts by the investors is as follows:
  - If the investor claims the money within 3 years, then payment is based on prevailing NAV i.e. after adding the income earned on the unclaimed money.
  - If the investor claims the money after 3 years, then payment is based on the NAV at the end of 3 years.

Proceeds of Illiquid Securities

- If the amounts are substantial, and recovered within 2 years, then the amount is to be paid to the old investors
- In other cases, the amount is to be transferred to the Investor Education Fund maintained by each mutual fund.

Can A Mutual Fund Scheme Go Bust?

- While the AMC manages the investments of the scheme, the assets of the scheme are held by the Custodian (custodian has custody of the investments in a scheme).
- Both operate under the overall control of the Trustees. This system of checks and balances protects the investors from misappropriation of funds, fraud etc.
- Even if some sponsors wish to move out of the business, they need to bring in some other sponsor, acceptable to SEBI, before they can exit.
- **Therefore, unlike the occasional experience of 'vanishing companies' in shares, mutual funds cannot vanish.**
- These structural requirements ensure that **the investor is fully protected** from most of the contingencies that can be envisaged.

End of the chapter…

CHAPTER 4

OFFER DOCUMENT

Process Of NFO

- The AMC decides on a scheme to take to the market.
- AMC prepares the Offer Document for the NFO. This needs to be approved by the Trustees and the Board of Directors of the AMC.
- The documents are filed with SEBI. **SEBI does not Approve/Disapprove the OD it given only the observation.** The observations that SEBI makes on the Offer Document need to be incorporated.
- After approval by the trustees, the Offer Document can be issued in the market.
- The AMC decides on a suitable time-table for the issue, keeping in mind the market situation.

Relevant Dates For NFO

- **NFO Open Date** – This is the date from which investors can invest in the NFO
- **NFO Close Date** – This is the date up to which investors can invest in the NFO
- **Scheme Re-Opening Date** – Only incase of open ended funds.
- Close-ended Schemes have an NFO Open Date and NFO Close Date. But, they have no Scheme Re-opening Date. Investors will need to go to the stock exchange(s) where the scheme is listed Post - NFO.

The Role of Offer Document

- The Offer Document is one of the most important sources of information on the scheme, to help prospective investors evaluate the merits and demerits of investing in it. **OD is the Operating Document and describes the product.**
- Mutual Fund Offer Documents have two parts:
  - **Scheme Information Document (SID)**
    - **Which has details of the scheme.**
  - **Statement of Additional Information (SAI)**
    - **Which has statutory information about the mutual fund, that is offering the scheme.**

The Role of Offer Document

- In practice, SID and SAI are two separate documents, though **the legal technicality is that SAI is part of the SID.**
- Both documents are prepared in the format prescribed by SEBI, and submitted to SEBI.
- The documents are prepared in simple language, and in clear, concise and easy to understand style.

Scheme Information Document (SID)

- The SID mentions the proposed asset allocation mix and nature of investments in which the moneys of the scheme will be deployed. However, names of specific securities where the scheme will invest are obviously not mentioned.

- **Contents of SID**
  - The cover page has the name of the scheme followed by its type viz.
    - Open-ended / Close-ended / Interval (the scheme structure)
    - Equity / Balanced / Income / Debt / Liquid / ETF (the expected nature of scheme portfolio)
  - It also mentions
    - Face value of the Units being offered
    - Relevant NFO dates (opening, closing, re-opening),
    - Date of SID
    - Name of the mutual fund, and name & contact information of the AMC and trustee company.

Scheme Information Document (SID)

- Table of Contents
- Highlights
- Introduction
  - Risk Factors
    - Standard
    - Scheme-specific
  - Provisions regarding minimum no. of investors in the scheme
  - Any other special considerations
  - Definitions
  - Due Diligence Certificate (issued by the AMC)
- Information about the scheme
- Units and Offer
- Fees & Expenses
- Rights of Unit-holders
- Penalties, Litigation etc.

Scheme Information Document (SID)

- The SID mentions the proposed asset allocation mix and nature of investments in which the moneys of the scheme will be deployed.
- Draft SID is a public document, available for viewing in SEBI's website (www.sebi.gov.in) for 21 working days.
- The final SID (after incorporating SEBI's observations) has to be hosted on AMFI's website (www.amfiindia.com) two days before the issue opens.
- **SEBI has also instituted a product labelling system**
  - Nature of scheme such as to create wealth or provide regular income in an indicative time horizon (short/ medium/ long term).
  - A brief about the investment objective (in a single line sentence) followed by kind of product in which investor is investing (Equity/Debt).

Scheme Information Document (SID)

- **SEBI has also instituted a product labelling system**
- Level of risk, depicted by colour code boxes as under:
  - **Blue** – principal at low risk.
  - **Yellow** – principal at medium risk.
  - **Brown** – principal at high risk.
- The colour codes should also be described in text beside the colour code box.
  - A disclaimer has to be included, that investors should consult their financial advisers if they are not clear about the suitability of the product.

Scheme Information Document (SID)

- **The product labels are to be disclosed in :**
  - » Front page of initial offering application forms, Key Information Memorandum (KIM) and Scheme Information Documents (SIDs).
- The product label is to be placed in proximity to the caption of the scheme and shall be prominently visible.
- Common application form – along with the information about the scheme.
- The product label is to be placed in proximity to the caption of the scheme and shall be prominently visible.
- Scheme advertisements – placed in manner so as to be prominently visible to investors.

Statement of Additional Information (SAI)

- » It contains every detail regarding the fund house other than a particular scheme for which investors wants to apply.
- » So, it is obvious to understand that single SAI is relevant for all the schemes offered by a mutual fund.

Contents of SAI :

- » Information about Sponsors
- » AMC and Trustee Company (includes contact information, shareholding pattern, responsibilities, names of directors and their contact information)
- » Profiles of key personnel, and contact information of service providers {Custodian, Registrar & Transfer Agent, Statutory Auditor, Fund Accountant (if outsourced) and Collecting Bankers}

Statement of Additional Information (SAI)

- **Contents of SAI :**
  - Condensed financial information (for schemes launched in last 3 financial years)
  - How to apply
  - Rights of Unit-holders
  - Investment Valuation Norms
  - Tax, Legal & General Information (including investor grievance redressal mechanism, and data on number of complaints received and cleared, and opening and closing number of complaints for previous 3 financial years and for the current year to-date).
- Every mutual fund, in its website, provides for download of its SAI. Investors have a right to ask for a printed copy of the SAI.

Key Information Memorandum (KIM)

- KIM is essentially a summary of the SID and SAI.
- **As per SEBI regulations, every application form is to be accompanied by the KIM.**

Key Information Memorandum (KIM)

- **Contents of KIM :**
  - Name of the AMC, mutual fund, Trustee, Fund Manager and scheme
  - Dates of Issue Opening, Issue Closing & Re-opening for Sale and Re-purchase
  - Plans and Options under the scheme
  - Risk Profile of Scheme
  - Price at which Units are being issued and minimum amount / units for initial purchase, additional purchase and re-purchase
  - Bench Mark
  - Dividend Policy
  - Performance of scheme and benchmark over last 1 year, 3 years, 5 years and since inception.
  - Loads and expenses
  - Contact information of Registrar for taking up investor grievances

Updation

- **Scheme Information Document :**
  - **For the very First time Post – NFO**
    - **Scheme launched in the first 6 months of the financial year (say, April 2010)**
      - ✓ Within 3 months of the end of the **same financial year** **(i.e. by June 2011).**
    - **Scheme launched in the second 6 months of the financial year (say, October 2010)**
      - ✓ The first update of the SID is due within 3 months of the end of the **next financial year** **(i.e. by June 2012).**
  - **Regular Update**
    - **To be updated every year.**

Updation

- **Scheme Information Document :**
  - **Need Based :**
    - In case of change in the **fundamental attributes**
      - ✓ The SID has to be updated immediately after the lapse of the time period given to existing investors to exit the scheme **(30 Days)**.

Updation

- **Statement of Additional Information (SAI) :**
  - **Regular**
    - Regular update is to be done **by the end of 3 months of every financial year.**
  - **Need Based**
    - Material changes have to be updated on an ongoing basis and uploaded on the websites of the mutual fund and AMFI.
- **Key Information Memorandum (KIM) :**
  - **Regular**
    - **At least once a year.**
  - **Need Based**
    - Whenever there is need based change in SID or SAI.

Important Statements

- For any change in fundamental attributes, **SEBI and Trustee approval is required.** Investor approval is not needed as they are given 30 days exit window.
- OD issued for launching of a new schemes is **valid for a period of six months** and if the scheme is not launched within this period a fresh OD is required to be filed.
- The first time investor should read detailed offer document, once he has gained familiarity with the AMC, he can just refer to KIM.
- The OD is issued by the AMC on behalf of the trustees.
- The AMC is responsible for the information in the OD.
- **Please refer to contents of each documents. It is important.**

End of the chapter...

CHAPTER 5

FUND DISTRIBUTION

AND

CHANNEL MANAGEMENT PRACTICES

Distribution Channels

- **Individual Agents (Individual Financial Advisors - IFAs)**
  - Most important drawback with them is that IFAs do not have huge branch network.
- **Institutional Channels**
  - Private Distribution Companies (Brokerage firms, National Distributors)
  - Banks (Private and Foreign) and NBFCs
  - Post Offices
  - **They can work through Employees, Agents &/or Sub brokers.**

New Distribution Channels

- Technologies has opened the doors to newer ways…
  - **Internet**
    - Direct Interactions
    - Reduction in Cost
    - Convenience - Less paper work
    - High standards in Servicing the clients
  - **Stock Exchanges (BSE, NSE)**
    - High penetration
    - High volume of transactions
    - Cost effectiveness.

New Cadre of Distributors

- **A new cadre of distributors such as**
  - Postal agents
  - Retired government and semi-government officials (class III and above or equivalent)
  - Retired teachers and retired bank officers **with a service of at least 10 years**, and other similar persons (such as Bank correspondents).
  - a**re allowed to sell units of simple and performing mutual fund schemes through** simplified form of NISM certification and AMFI Registration.
  - Limited products are available for selling.

Pre-requisites To Become Distributor Of A Mutual Fund

- **Two Ways :**

1. Passing SEBI's prescribed **Certifying Examination (NISM Module V-A).**
2. Series V-B: Mutual Fund Foundation Certification Examination and Mutual Fund Foundation CPE Program have been specially designed by NISM for this new cadre of distributors.

KYD Requirements

- AMFI has introduced the KYD process to verify the correctness of the information provided in the registration documents and to have verification of the ARN holders.
- The process consists of document verification and bio-metric process.
- In case of non-individual distributors, bio-metric process will be conducted on specified authorized persons.
- The New Cadre of Distributors are not required to comply with KYD/ bio-metrics requirements.
- However, they are required to submit
  - » Self-attested copies of identity proof and
  - » Address proof, as mentioned in KYD application form.

AMFI Registration Process

- After passing the examination and completing KYD requirements, the next stage is to register with AMFI.
- AMFI allots an AMFI Registration Number (ARN).
- After receiving ARN, the IFA / distributor / stock exchange broker can get empanelled with any number of AMCs.
- The employees of the distributor need to obtain an Employee Unique Identification Number (EUIN) from AMFI apart from AMFI Registration Number (ARN).
- The Intermediaries have to ensure that the employees quote the EUIN in the Application Form for investments.

Channel Management Practices

- **Commission Structures**
  - There are no SEBI regulations regarding the minimum or maximum commission that distributors can earn.
  - However, SEBI has laid down limits on what the total expense (including commission) in a scheme can be. **Any excess will need to be borne by the AMC i.e. it cannot be charged to the scheme.**
  - The commission structures vary between AMCs. Even for the same AMC, different commissions are applicable for different kinds of schemes.

Channel Management Practices

Commission Structures

- **Initial or Upfront Commission**
  - Paid on the amount mobilized by the distributor.
  - Upfront commission to distributors will be **paid by the investor directly** to the distributor, based on his assessment of various factors including the service rendered by the distributor.
- **Trail Commission**
  - Calculated **as a percentage of the net assets** attributable to the Units sold by the distributor.
  - Distributors benefit from increase in net assets arising out of valuation gains in the market.
  - The trail commission is normally paid by the AMC on a quarterly basis.
  - Distributor is paid a commission for as long as the investor's money is held in the fund.
- **No commission – neither upfront nor trail – is payable to the distributor for their own investments (self business).**

Commission Disclosure

- SEBI has mandated Mutual Funds / AMCs to disclose on their respective websites the total commission and expenses paid to distributors who satisfy one or more of the following conditions with respect to non-institutional (retail and HNI) investors – **Same as Due diligence requirement**

  a. **Multiple point presence (More than 20 locations)**

  b. **AUM raised over Rs.100 crore across industry in the non-institutional category but including high net worth individuals (HNIs)**

  c. **Commission received of over Rs. 1 Crore p.a. across industry**

  d. **Commission received of over Rs. 50 Lakhs from a single mutual fund**

Multi-level Distribution Channel

- Large distributors have agents / sub-brokers working under them. Being the principal, the distributor is bound by the acts of agents / sub-brokers.
  - The distributor therefore needs to ensure that the agents comply with all the regulations.
- Typically, AMCs structure their relationship with distributors as Principal to Principal.
- Therefore, the AMC it is not bound by the acts of the distributor, or the distributor's agents or sub-brokers.

SEBI Regulations Related To Sales Practices

- The distributors have to disclose all the commissions (in the form of trail commission or any other mode) payable to them for the different competing schemes of various mutual funds from, amongst which the scheme is being recommended to the investor.
- The practice of rebating is banned.

SEBI Advertising Code

- In hoardings / posters, the statement, **"Mutual Fund investments are subject to market risks, read the offer document carefully before investing"**, is to be displayed in black letters of **at least 8 inches** height or **covering 10% of the display area**, on white background.
- In audio-visual media, the statement "Mutual Fund investments are subject to market risks, read the offer document carefully before investing" (without any addition or deletion of words) has to be displayed on the screen for at least 5 seconds, in a clearly legible font-size covering at least **80% of the total screen space and accompanied by a voice-over reiteration.** The remaining 20% space can be used for the name of the mutual fund or logo or name of scheme, etc.
- MF should not Promise any returns except in case of assured returns schemes.

Performance Advertisements

- The dividends declared or paid shall also be mentioned in Rupees per unit along with the face value of each unit of that scheme and the prevailing NAV at the time of declaration of the dividend.
- **Returns**

Tenure Since Inception	Type of Returns To Be Shown
Any Type of Scheme for more than 1 year	CAGR (for last 1 year, 3 years, 5 years)
For the schemes that are in existing for less than a year	
1. Liquid Scheme	Simple Annualized Yields (for at least 7 days, 15 days and 30 days)
2. Other than Liquid Schemes	Total Returns (without annualization)

SEBI Advertising Code

Guidelines for showing Returns of the Scheme

Risk Indicator

Scheme Benchmark

Additional Benchmark

Equity Scheme

HIGH RISK (BROWN)

Returns of Regular Plan - Growth Option as on Jun 30, 2013					
Particulars	June 30, 2012 to June 30, 2013	June 30, 2011 to June 30, 2012	June 30, 2010 to June 30, 2011	Since inception	
	Absolute Returns (%)	Absolute Returns (%)	Absolute Returns (%)	Current Value of Investment of Rs.10000	CAGR (%)
Scheme	5.24	0.04	6.87	51230.00	20.22
Benchmark	-0.13	-7.77	-1.96	35606.08	15.39
CNX NIFTY Index	10.67	-6.53	6.30	36533.16	15.73
NAV (Rs.) Per Unit (as on June 28,2013 : 51.23)	48.68	48.66	45.53	10.00	

SEBI Advertising Code

Guidelines for showing Returns of the Scheme

Risk Indicator

Scheme Benchmark

Additional Benchmark

Liquid / Money Market Scheme

LOW RISK (BLUE)

Returns of Regular Plan - Growth Option as on Jun 30, 2013

Particulars	7 Days	15 Days	30 Days	June 30, 2012 to June 30, 2013	June 30, 2011 to June 30, 2012	June 30, 2010 to June 30, 2011	Since inception	
	Returns (%)	Returns (%)	Returns (%)	Absolute Returns (%)	Absolute Returns (%)	Absolute Returns (%)	Current Value of Investment of Rs. 10000	CAGR (%)
Scheme	5.89	8.11	8.12	9.02	9.80	6.26	16576.00	7.16
Benchmark	6.94	9.04	8.25	8.12	8.68	7.18	16485.65	7.08
1 Year T Bill	4.50	3.76	4.36	8.17	7.73	4.43	15190.34	5.88
NAV (Rs.) Per Unit (as on June 28,2013 : 165.76)	165.57	165.25	164.73	152.05	138.48	130.33	100.00	

SEBI Advertising Code

Guidelines for showing Returns of the Scheme

Risk Indicator

Scheme Benchmark

Additional Benchmark

Long Term Debt Scheme

LOW RISK (BLUE)

Returns of Regular Plan - Growth Option as on Jun 30, 2013					
Particulars	June 30, 2012 to June 30, 2013	June 30, 2011 to June 30, 2012	June 30, 2010 to June 30, 2011	Since inception	
	Absolute Returns (%)	Absolute Returns (%)	Absolute Returns (%)	Current Value of Investment of Rs. 10000	CAGR (%)
Scheme	10.53	7.25	4.04	30453.40	8.36
Benchmark	9.27	9.30	4.25	NA	NA
10 Year G Sec	12.10	7.10	1.79	NA	NA
NAV (Rs.) Per Unit (as on June 28,2013 : 30.4534)	27.55	25.69	24.69	10.00	

End of the chapter…

CHAPTER 7

INVESTOR SERVICES

Eligibility To Invest

- **Individual Investors** : Resident Indian adult individuals, Minors through their Parents/Lawful guardians.
- **Hindu Undivided Families (HUFs)**
- **Non-Resident Indians (NRIs) /Persons of Indian origin (PIO)**
- **Foreign investors**
- **Non-individual Investors**
  - Companies / corporate bodies, registered in India
  - Registered Societies and Co-operative Societies
  - Trustees of Religious and Charitable Trusts
  - Trustees of private trusts
  - Partner(s) of Partnership Firms
  - Foreign Institutional Investors (FIIs) registered with SEBI
  - Association of Persons or Body of Individuals, whether incorporated or not
  - Banks etc…

Other Category

- **The following were not permitted to invest in mutual funds in India until recently:**
  - An individual who is a foreign national (unless of course, the person is an NRI or PIO / OCI card holder.
  - Any entity that is not an Indian resident, as per FEMA (except when the entity is registered as FII with SEBI, or has a sub-account with a SEBI-registered FII).
  - Overseas Corporate Bodies (OCBs) i.e. societies / trusts held, directly or indirectly, to the extent of over 60% by NRIs, or trusts where more than 60% of the beneficial interests is held by such OCBs.

Other Category

- SEBI and RBI circulars dated August 9, 2011 have allowed Qualified Foreign Investors (QFIs) who meet KYC requirements to invest in equity and debt schemes of Mutual Funds through two routes:
  - » **Direct Route -** Holding MF units in demat account through a SEBI registered depository participant (DP).
  - » **Indirect Route -** Holding MF units via Unit Confirmation Receipt (UCR).
- **It is always a good practice to check the 'Who can Invest' section of the Offer Document.**

KYC Requirements

- **The following investors have to be KYC compliant, irrespective of the investment value (Even if the investment is less than Rs. 50,000 – discussed later):**
  - Non-individual investors i.e. companies, partnership firms, trusts, HUF etc.
  - Non-Resident Indians
  - Investors coming through channel distributors

KYC - Process

- The requisite form is to be filed along with supporting documents.
- The supporting documents will be verified with the original. Alternatively, the investor can provide a True Copy.
- The original is returned to the investor, after verification, while the forms and supporting documents are uploaded in the server of any centralized KRA.
- The intermediaries mentioned above are also authorised to perform an In Person Verification of the investor.
- **Where investment is made by a minor, KYC requirements have to be complied with by the Guardian.**
- **In the case of investments by a Power of Attorney holder on behalf of an investor, KYC requirements have to be complied with, by both, investor and PoA holder.**

KYC Requirements - Documents

- **Proof of Identity**
- **Proof of Address**
- **PAN Card**
- **Photograph**
- **KYC is required to be done through Centralised KYC Registration Agencies (KRAs) for the benefit of investors.**
- **Once done, the investor does not need any further KYC for dealing in any part of the securities market (depository, stock exchange transactions, mutual fund transactions etc.).**

PAN Card Requirements for Micro-SIPs

- PAN Card is compulsory for all mutual fund investments. Exception has been made for Micro-SIPs.
  - SIPs where annual investment (12 month rolling or April-March financial year) does not exceed Rs 50,000.
  - Instead, the investors (including joint holders) can submit PHOTO IDENTIFICATION (given on page no. 145) documents along with Micro SIP applications.
- Investors have to give a declaration for Micro – SIP.
- It may be noted that the relaxation in documentation requirements for micro-SIPs is not available for HUFs and non-individuals.
- **Such relaxation is available for NRIs, but not PIOs.**

Additional Documentation Requirements for Institutional Investors

- Documentation requirements for institutional investors are in addition to the normal KYC documentation.
- If incorporation documents (Memorandum of Association and Articles of Association or Trust Deed) don't give permission to invest in MF, then they can't invest in the same.
- This can be changed with help of Board Resolution.
- Authorization for the official to sign the documents on behalf of the investing institution.

Demat Account

- ***Dematerialisation*** is a process whereby an investor's holding of investments in physical form (paper), is converted into a digital record.
- Once the KYC is performed for opening a demat account, no separate KYC is required to be done by the AMC or distributor.
- **Benefits**
  - » Less paperwork
  - » Direct credit of bonus and rights units
  - » Change of address or other details need to be given only to the Depository Participant
- The investor also has the option to convert the demat units into physical form. This process is called ***re-materialisation.***

Transactions With Mutual Funds

- **Fresh Purchase**
- **Additional Purchases**
- **Online Transactions –** Based on name and password (Personal Identification Number – PIN)

Payment Mechanism for Purchase / Additional purchase

- **Mutual funds usually do not accept cash but**
- Small investors
  - Who may not be tax payers and
  - May not have PAN/bank accounts
  - are allowed cash transactions for purchase of units in mutual funds to the extent of **Rs. 20,000/- per investor, per mutual fund, per financial year.**
- Although investment can be made in cash, repayment in form of redemptions, dividend payments etc. can be only through the banking channel.

Payment Mechanism for Purchase / Additional purchase

- **Cheque / Demand Draft (DD) :**
  - Required for investment / for additional purchase
  - NRI / PIO applications need to be accompanied by cheque drawn on an NRO account (for non-repatriable investment) or NRE account (for repatriable investment).
  - If payment from NRI is by DD, and investment is on repatriable basis, a banker's certificate -**Foreign Inward Remittance Certificate (FIRC)** will be required to the effect that the DD has come out of moneys remitted from abroad.
  - **Third-party cheques are not accepted except in special cases such as grandparents/parents making payments not exceeding Rs. 50,000** on behalf of a minor, employer making payments on behalf of employee through payroll deductions and custodian on behalf of FIIs.
  - Payment can also be done through NEFT, RTGS or SWIFT and through ECS for SIP.

Application Supported by Blocked Amount (ASBA)

- The benefit of ASBA is that the money goes out of the investor's bank account only on allotment.
- Until then, it keeps earning interest for the investor.
- ASBA facility is available only for NFO, it cannot be used for the purchase of ongoing scheme.

Allotment of Units

- Since entry load is banned, Units in an NFO are sold at the face value i.e. Rs. 10. So the investment amount divided by Rs. 10 would give the number of units the investor has bought.
- The price at which units are sold to an investor as part of ongoing sales in an open-end scheme is the **sale price**, which in turn is the **applicable NAV**.
- Thus, an investor who has invested Rs. 12,000, in a scheme where the applicable sale price is Rs. 12, will be allotted Rs. 12,000 ÷ Rs. 12 i.e. 1,000 units.
- However, in case of subscription/purchase above Rs. 10,000/- for application sourced from a distributor, in case the distributor has opted to receive transaction charges, a transaction charge of Rs. 100 (in case of an existing investor) or Rs. 150 (in case of an investor other than an existing investor) shall be deducted from the investment amount.

Payment Mechanism for Repurchase of Units

- **Cheque**
- **Direct Credit**
- It may be noted that for non-resident investors, payment is made by the AMC in rupees.
- In case the investment has been made on repatriable basis, and the investor wishes to transfer the moneys abroad, **the costs associated with converting the rupees into any foreign currency would be to the account of the investor.**

Cut-off Time – Very Important

- **SEBI has prescribed cut-off timing to determine the applicable NAV.**

Type of Scheme	Transaction	Cut off time	Applicable NAV
Equity oriented funds and debt funds (except liquid funds) in respect of purchases **less than Rs. 2 lacs**	• Purchases • Switch In	3.00 pm	• Same day NAV if received before cut off time. • Next business day NAV for applications received after cut off time.
Equity oriented funds and debt funds (except liquid funds) in respect of transaction **more than Rs. 2 lacs**	• Purchases • Switch In	3.00 pm	**Irrespective of the time of receipt of application,** • NAV of the business day on which the funds are available for utilisation before the cut-off time of that day is applicable.
Liquid fund	• Purchases • Switch In	2.00 pm	• Previous day NAV if received before cut off time and funds are realised. • If received after cut off time, NAV of the day previous to funds realisation.
Equity Oriented Funds, Debt funds, Liquid funds	• Redemptions • Switch out	3.00pm	• Same day NAV if received before cut off time. • Next business day NAV for applications received after cut off time.

Time Stamping

- The time stamping on the transaction requests is done at the official points of acceptance.
- These points of acceptance have time stamping machines with tamper-proof seal.
- Opening the machine for repairs or maintenance is permitted only by vendors or nominated persons of the mutual fund. Such opening of the machine has to be properly documented and reported to the Trustees.
- **The daily time stamping of application does not start with serial 1.**
- **Application are stamped with automatically generated Location Code, Machine identifier, Serial number, Date & Time.**
- **Similarly applications for non-financial transactions like change of address, and investor's acknowledgement are stamped.**
- **For online transactions, the time as per the web server to which the instruction goes, is used in determining the NAV for sale / re-purchase transactions.**

Transactions Through The Stock Exchange

- **NSE's platform is called NEAT MFSS. BSE's platform is BSE STAR.**
- Both platforms are open from 9 am to 3 pm on every working day.
- Fresh, additional purchase and redemption are permitted.
- **Stock exchanges only offer a transaction platform, they do not offer Settlement Guarantee.** Responsibility for settlement is that of the AMC.

Investment Plans

- **Growth**
- **Dividend Payout and**
- **Dividend Re-Investment Option**
- **The portfolio returns are the same for all three options.** However, they differ in the structure of cash flows and income accruals for the unit-holder, and therefore, the Unit-holder's taxability, number of units held and value of those units.
- **Dividend is declared in both, Dividend Payout and Dividend Re-investment Option.**
- The day on trustee approves the dividend is called CUM – Dividend-NAV.
- Reduced NAV after the dividend is paid is called Ex- NAV. Dividend is invested at Ex-NAV in Divided Re-investment option.

Investment Plans

Parameter	Dividend Payout Option	Dividend Re-investment Option	Growth Option
Dividend received in bank account	Yes	No	No
Income Distribution Tax	Yes, for non-equity schemes	Yes, for non-equity schemes	N.A.
Increase in number of units on account of re-investment of dividend	No	Yes	No
NAV change	NAV declines to the extent of dividend and income distribution tax	NAV declines to the extent of dividend and income distribution tax	NAV changes as per the market valuations. Declaration of dividend in other options has NO impact on NAV of growth option.

Investment Services

- **Triggers**
  - » Helps to transact at the pre-specified price without any additional requirements at that time.
- **Statement of Account and Investment Certificate**
  - » Statement of Account shows for each transaction (sale / re-purchase), the value of the transaction, the relevant NAV and the number of units transacted. Besides, it also provides the closing balance of units held in that folio, and the value of those units based on the latest NAV.
- **Annual Account Statement**
  - » The Mutual Funds shall provide the Account Statement to the Unit-holders who **have not transacted during the last six months prior to the date of generation** of account statements.
  - » The Account Statement shall reflect the latest closing balance and value of the Units prior to the date of generation of the account statement.

Investment Services

- **Consolidated Account Statement (CAS)**
  - A Consolidated Account Statement (CAS) for each calendar month will be sent by post/email **on or before 10th of the succeeding month.**
  - If an email id is registered with the AMC, only a CAS via email will be sent.
  - **Investors will be identified across mutual funds by their Permanent Account Number (PAN).**
  - **where there are no transactions in a folio during any six month period**, a CAS detailing holding across all schemes of all mutual funds at **the end of every such six month period** (i.e. September/March), shall be sent by post/e-mail **by the 10th day of the month following that half year,** to all such Unit holders.

Investment Services

- **Nomination**
  - If one joint holder dies, then the Units will continue to be held by the surviving joint holder/s. If the sole Unit-holder or all joint holders die/s, then the Units will be transferred to the nominee.
  - **Maximum 3 nominations can be made.**
- **Pledge**
  - Mutual funds units can be pledged by unit holders to Banks, NBFCs and other financiers.
  - Once Units are pledged, the Unit-holder/s cannot sell or transfer the pledged units, until the pledgee gives a no-objection to release the pledge.

Important

- **Investor has the option to decide on the repurchase (redemption) amount (which is generally the case) or number of units offered for re-purchase, where sale (purchase) application can be done only in amount.**
- RTGS means Real time gross settlement.
- NEFT means National Electronic funds transfer.
- SWIFT used for international transfer.

End of the chapter…

Test Time...

Test Time…

1. Mutual fund in India is constituted as…

   a. Companies

   b. Trust

   c. Partnership Firm

   d. NGO

2. Cut-off timing guidelines are not applicable for _____.

   a. NFOs

   b. International Funds

   c. Both the above

   d. None of the above

Test Time…

3. Compare to Sector Funds, Thematic Fund would have a wider choice for investment.

    a. True

    b. False

4. Close ended fund allows investors to sell their units

    a. By allowing fixed number of Units to sell

    b. By selling number of units in a fixed interval

    c. By listing MF in stock exchange

    d. Can not sale

Test Time…

5. One of the advantage of ETF is..

   a. Investor can see where his money is invested

   b. These schemes can generate higher returns than mutual fund

   c. Investors can buy of sell units on stock exchanges at price that closely track valuation at that time

   d. ETF offer tax benefits

6. Minimum Net worth needed by AMC ?

   a. 10 Cr b. 15 Cr c. 20 Cr d. 5Cr.

7. Mutual Fund sponsor can be compared to

   a. Depositor of a company b. Company director

   c. Promoter of Company d. CEO of a company

Test Time...

8. The asset management company shall confirm that a due diligence certificate is signed by the Compliance Officer

   a. True b. False

9. Bank owned mutual funds are regulated by

   a. RBI and SEBI b. Respective parent banks c. RBI d. SEBI

10. If payment of redemption is delayed then what % of interest has to be paid by AMC ?

    a. 10% b. 20% c. 9% d. 15%

11. The distributor can charge fees from the Investor

    a. True b. False

Test Time…

12. Which of the following is Self Regulatory Organization (SRO)?

    a. BSE b. SEBI c. RBI d. AMFI

13. Newly drafted Offer Document, after getting registered with SEBI is valid for ?

    a. 1 month b. 3 months c. 6 months d. 1 year.

14. The correct frequency for updating Offer Document is

    1. The OD must be updated whenever there is a material change in its contents.
    2. The OD must be updated on a yearly basis.

    a. Only (1) is right

    b. Only (2) is right

    c. Both of them are right

    d. None of them is right

Test Time...

15. It is mandatory to attach KIM with
    a. Transaction slip
    b. Application form
    c. Both of them
    d. None of them
16. NFO other than ELSS can remain open for a maximum of ________ days
    a. 7 b. 10 c. 15 d. 30
17. Distributors do not get commission on self business
    a. True b. False

Test Time...

18. Which one of the following statements is correct?
    a. An individual agent can distribute/sell only one mutual fund's products
    b. Any category of distributors/agents can distribute as many of the mutual funds' products as allowed by the concerned AMCs
    c. Banks are not allowed to sell mutual fund products, except their own funds
    d. A distribution company can distribute/sell only one mutual fund's products

19. In India one can invest in MF through distributor only.
    a. True   b. False

Test Time...

20. Which of the following would not affect the trail commission to the advisor in mutual Fund

    a. AUM going up with the increase in the market

    b. Investor making fresh purchase during the period

    c. Change in the unit capital of the scheme

    d. Investor redeeming investment during the period

21. Open-ended schemes generally offer exit option to investors through a stock exchange.

    a. True   b. False

22. AMC directors are appointed with the permission of Trustees.

    a. True   b. False

Test Time…

23. Most investor service centres are offices of ________.

    a. Trustees | b. Registrar

    c. AMCs | d. Fund Accountant

24. SEBI regulates ___________.

    a. Mutual Funds | b. Depositories

    c. Registrar & Transfer Agents | d. All of the above

25. Legally, SAI is part of the SID.

    a. True | b. False

26. Offer documents of mutual fund schemes are approved by SEBI.

    a. True | b. False

Test Time...

27. KIM has to be updated every 6 months.

    a. True b. False

28. Stock exchange brokers are permitted to distribute mutual funds without the requirement of passing the certifying test.

    a. True b. False

29. Foreign nationals are permitted to invest in Indian mutual funds, subject to KYC.

    a. True b. False

30. PAN Card is not required for mutual fund investments below Rs 20,000, where payment is in cash.

    a. True b. False

End of Day 1…

CHAPTER 8

RETURN, RISK & PERFORMANCE OF FUNDS

Drivers Of Returns In A Scheme

- The portfolio is the main driver of returns in a mutual fund scheme. The underlying factors are different for each asset class.

Equity Schemes

- **Securities Analysis Disciplines**
  - » **Fundamental Analysis and**
  - » **Technical Analysis**
- A passive fund manager does not need to go through this process of securities analysis, but securities analysis is an important aspect of actively managed schemes.

Fundamental Analysis

- **EPS : Total earnings per share.**

$$\frac{\textbf{Net Profit after tax (for equity share holders)}}{\textbf{No. of shares outstanding}}$$

- Net profit of the company - Rs. 1000 crores
- No. of equity shares outstanding - 100 crores
- **EPS = (Rs. 1000 crore / 100 crore) = Rs. 10**
- This tells investors how much profit the company earned for each equity share that they own.

Fundamental Analysis

- **Price to Earnings Ratio (P/E Ratio) :**

$$\frac{\textbf{Market value per share}}{\textbf{EPS}}$$

- Market Price of the share - Rs. 50
- Earnings per share - Rs. 10
- **P/E Ratio = (Rs. 50 / Rs. 10) = 5**
- **A low P/E is not a buy always, and a High P/E is not a sell always. It is based on the expectation of future performance of the company.**

Fundamental Analysis

- **Book value :** Value of company's asset per share that share holders will receive if company goes into liquidation.

$$\frac{\textbf{Paid up equity cap + Reserves \& Surplus}}{\textbf{No. of Shares Outstanding}}$$

- Paid up Capital - Rs. 1000 crore
- Reserves and Surplus - Rs. 250 crore
- No. of Outstanding Shares - 100 crores
- **(Rs. 1000 crores + Rs. 250 Crores) / 100 crores = Rs. 12.50**

Fundamental Analysis

- **Price to Book Value :** An indicator of how much the share market is prepared to pay for each share of the company, as compared to its book value.

$$\frac{\textbf{Market Price}}{\textbf{Book Value per Share}}$$

- Market Price of Share - Rs. 50
- Book Value per share - Rs. 12.50
- **Price to Book Value - (Rs. 50 / Rs. 12.50) = 4**
- Most financial indicators cannot be viewed as stand-alone numbers.
- They need to be viewed in the context of unique factors underlying each company.

Technical Analysis

- Technical Analysts believe that price behaviour of a share, and the volumes traded are a reflection of investor sentiment, which in turn will influence future price of the share.
- **Technical annalists are also called CHARTISTS.**
- It is generally agreed that longer term investment decisions are best taken through a fundamental analysis approach, while technical analysis comes in handy for shorter term speculative decisions, including intra-day trading and even to time the market for decisions based on fundamental analysis.

Investment Styles

- **Growth Investment Style :**
  - These stocks of companies are likely to grow much faster than the economy.
  - Valuation of these stocks tends to be on the higher side.
  - **In the event of a market correction, these stocks tend to decline more.**
- **Value Investment Style :**
  - An approach of picking up stocks, which are **valued lower**, based on fundamental analysis.
  - In this, if investor's decision is proved right, they earn very high returns, which more than offset the losses on failed decisions.

Investment Styles

TOP DOWN

Economy e.g. High Growth

Industry e.g. retail

Company

BOTTOM UP

Bottom Up approach is also known as Stock – Picking approach.

Debt

- It entails a return in the form of interest (at a pre-specified frequency for a pre-specified period), and refund of a pre-specified amount at the end of the pre-specified period.
- The pre-specified period is also called ***Tenor.***
- At the end of the tenor, the securities are said to ***Mature.*** The process of repaying the amounts due on maturity is called ***Redemption.***
- The return that an investor earns or is likely to earn on a debt security is called its *Yield. Yield = Interest Income + Capital Gain / Capital Loss*
- **Debt securities that are to mature within a year are called money market securities.**

Introduction To Debt Securities

- Debt securities may be issued by Central Government, State Governments, Banks, Financial Institutions, Public Sector Undertakings (PSU), Private Companies, Municipalities etc.
- Securities issued by the Government are called **Government Securities or G-Sec or Gilt.**
- **Treasury Bills** are short term debt instruments issued by the Reserve Bank of India on behalf of the Government of India.
- **Certificates of Deposit** are issued by Banks (for 91 days to 1 year) or Financial Institutions (for 1 to 3 years)
- **Commercial Papers** are short term securities (up to 1 year) issued by companies.
- **Bonds / Debentures** are generally issued for tenors beyond a year. **Governments and public sector companies tend to issue bonds, while private sector companies issue debentures.**

Credit Rating And Credit Rating Agencies

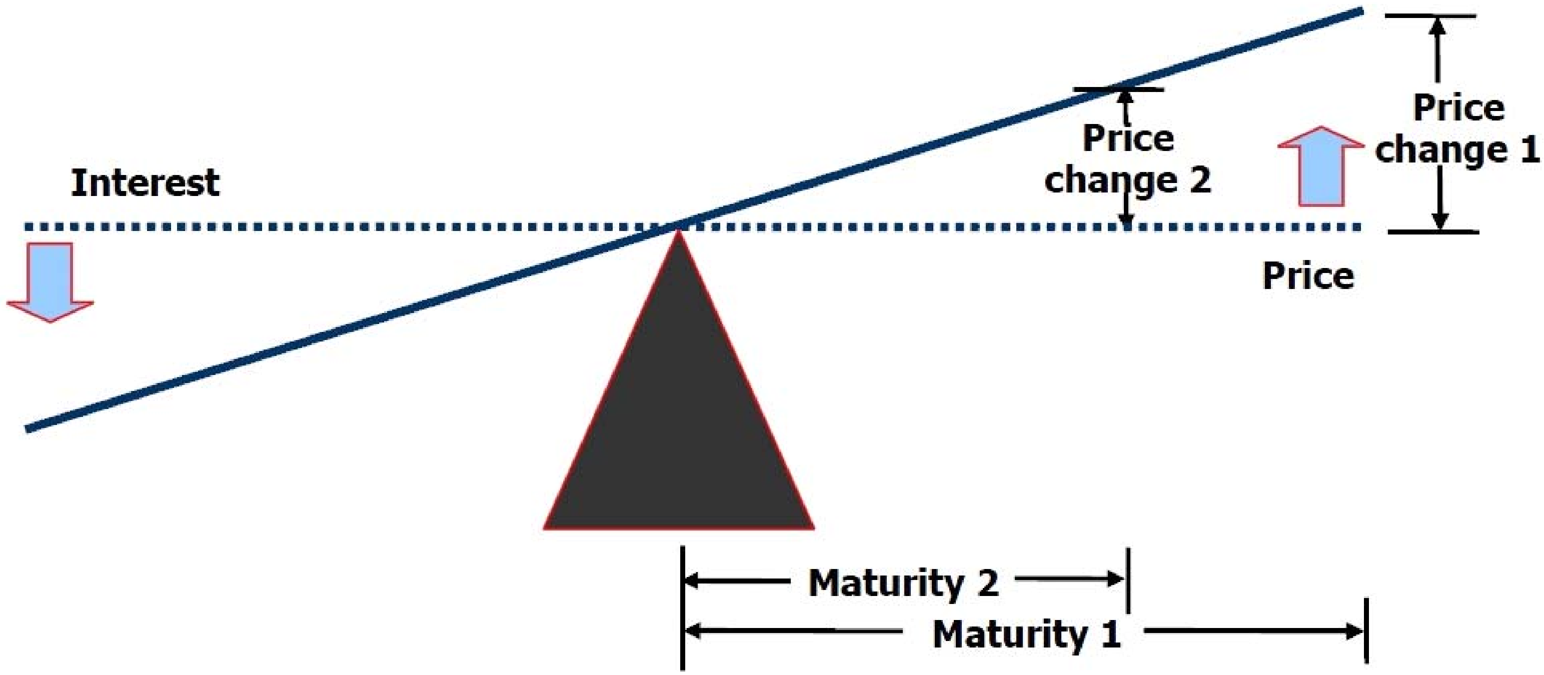
- The possibility of a non-government issuer defaulting on a debt security i.e. its **Credit Risk.**
- It is measured by Credit Rating companies like
  - » CRISIL, ICRA, CARE and Fitch.
- They assign different symbols to indicate the credit risk in a debt security. For instance **'AAA' is CRISIL's indicator of highest safety in a debenture.**
- Higher the credit risk, higher is likely to be the yield on the debt security.
- **The interest rate offered by company fixed deposits depends on the credit rating assigned.**
- The difference between the yield on Gilt and the yield on a Non-Government Debt security (with highest safety, i.e. AAA or equivalent) is called its ***Yield Spread.***

Introduction To Debt Securities

- Debt securities can be of three types
  - Fixed Rate
  - Floating Rate
  - Zero Coupon – T-bills
- **As discussed earlier, NAVs of Floating Rate Schemes fluctuate lesser than debt funds that invest more in debt securities offering a fixed rate of interest.**

Interest Rates And Bond Prices

- **Interest rates and Market price of debt security are *inversely related* to each other.**



- A security of longer maturity would fluctuate a lot more, as compared to short tenor securities. This can be measured by **modified duration.**

Gold

- The value of gold in India depends on the international price of gold (which is quoted in foreign currency), the exchange rate for converting the currency into Indian rupees, and any duties on the import of gold.
- Gold is seen as a safe haven asset class. Therefore, whenever there is political or economic turmoil, gold prices shoot up.
- **Impact of Rupee Valuation :**
  - **Depreciation of home currency - Better returns in Gold (International Asset)**
  - **Appreciation of home currency - Low returns in Gold (International Asset)**

Real Estate

- **Factors affecting Real Estate Prices :**
  - » **Economic scenario**
  - » **Infrastructure development**
  - » **Interest Rates**

Returns

- **Simple Return**
  - » The Simple Return can be calculated with the following formula:

$$\frac{\textbf{Later Value minus Initial Value}}{\textbf{Initial Value}} * 100$$

- Suppose you invested in a scheme, when its NAV was Rs 12. Later, you found that the NAV has grown to Rs 15. How much is your return?

$$= [\ (15 - 12)\ /\ 12] * 100 = 25\%$$

Returns

- **Annualized Return**
  - » The annualized return can be calculated as

$$\frac{\textbf{Simple Return * 12}}{\textbf{Period of Simple Return (In Months)}}$$

- Continuing with the same example, if the Simple Return is achieved in, say, 8 months, the annualized return would be :

= (25% * 12) / 8 = 37.50%

Compounded Return

- In previous two examples effect of compounding is missing.

$$\left(\left(\frac{\text{Later Value}}{\text{Initial Value}} \right) ^{\wedge\, 1/N} - 1 \right) * 100$$

- **Frequency of compounding can be any.**

Compounded Annual Growth Rate

- The formula is same as Compounded Return.

$$\left[\left(\frac{\textbf{Later Value}}{\textbf{Initial Value}} \right)^{\wedge\, 1/N} - 1 \right] * 100$$

- But here the frequency of compounding will be annual only.
- Load will reduce overall return of the portfolio.
- **Mutual funds are not permitted to promise any returns, unless it is an assured returns scheme. Assured returns schemes call for a guarantor who is named in the offer document.**

Drivers Of Risk In A Scheme

- **Portfolio Risk**
  - This is related to performance of the assets in the portfolio, but there is no certainty regarding the performance of the selected assets classes by the fund manager.
- **Portfolio Liquidity**
  - If assets lying in the portfolio is Liquid, profits can be booked when required.
  - SEBI has laid down criteria to identify illiquid investments, and also set a ceiling to the proportion of such illiquid investments in the net assets of a scheme.
  - **The ceiling is lower for open-ended scheme, which have a greater need for liquidity because investors can offer their units for re-purchase at any time.**

Drivers Of Risk In A Scheme

- **Liquid assets in the scheme :**
  - **Two reasons to keep liquidity.**
    - They believe that the market is over-heated, and therefore prefer to sell their investments and hold the proceeds in liquid form, until the next buying opportunity comes up.
    - They want to provide for contingencies such as impending dividend payment or re-purchase expectations.
- **Higher the liquid assets in the scheme, lower is the return of the scheme but at the same time they protect the scheme from any distress sale of investments.**

Liabilities In The Scheme

- The outside liabilities need to be paid by a scheme, irrespective of the performance of the assets.
- **Outside liabilities add to the risk in a mutual fund scheme.**
- **Until the expenditure is paid, it is a liability in the scheme.**
- The practice of taking liabilities beyond what is inherent to the normal business of a mutual fund scheme is called ***leveraging*. *Limits for the same :***
  - A mutual fund scheme cannot borrow more than **20%** of its net assets
  - The borrowing cannot be for more than **6 months.**
  - The borrowing is permitted only to meet the cash flow needs of investor servicing viz. dividend payments or re-purchase payments.

Drivers Of Risk In A Scheme

- **Use Of Derivatives**
  - It can be used for the purpose of
    - *Hedging against risk*
    - *Re-balancing the portfolio*
  - Mutual Funds are barred from writing options.
- **Unit Holders Churn**
  - **As a measure to protect the investor, SEBI has stipulated the 20:25 rule viz. every scheme should have at least 20 investors; no investor should represent more than 25% of net assets of a scheme.**

Risk In Equity Funds

- In the long run, equity markets are a good barometer of the real economy – but in the short run, markets can get over-optimistic or over-pessimistic, leading to spells of greed and fear.
- Equity markets therefore tend to be volatile.

Portfolio Specific Risk

- **Sector Funds** suffer from concentration risk - the entire exposure is to a single sector. Performance of the scheme will depend up on performance of one sector only.
- **Diversified Equity Funds**, on the other hand, have exposure to multiple sectors. Diversified equity funds are therefore less risky than sector funds.
- **Thematic Funds** are a variation of sector funds. It is discussed in Chapter 1.
- Mid Cap Funds invest in mid cap stocks, which are less liquid and less researched in the market, than the frontline stocks. Therefore, the liquidity risk is high in such portfolios.
- **Contra Funds** take positions that are contrary to the market. Such an investment style has a high risk of misjudgments.

Portfolio Specific Risk

- **Dividend Yield Funds** invest in shares whose prices fluctuate less, but offer attractive returns in the form of dividend. Such funds offer equity exposure with lower downside.
- **Arbitrage Funds** are categorized as equity funds. Risk is the lowest among equity funds – even lower than diversified equity funds. The returns too are lower – more in line with money market returns, rather than equity market returns.

Risk in Debt Funds

- There is assured value on maturity, but debt securities fluctuate in value, with changes in yield in the overall market.
- A fund manager taking a wrong call on the direction of interest rates can seriously affect the scheme performance.
- Because of Illiquidity in Non – Government Debt Market, an element of subjectivity creeps into their valuation, and therefore the NAV.
- **Short maturity securities (lower modified duration) suffer lesser fluctuation in value, as compared to the ones with longer tenor (higher modified duration).**

Risk in Debt Funds

- **Fixed Maturity Plan's (FMP)** yield is relatively more predictable on maturity but in the interim, the value of these securities will fluctuate in line with the market – and therefore, the scheme's NAV too will fluctuate.
- **If the FMP is structured on the basis of investment in non-government paper, then the credit risk is also an issue.**

Risk In Balanced Funds

- **Balance Schemes :**
  - It is rare for both debt and equity markets to fare poorly at the same time. Since the performance of the scheme is linked to the performance of these two distinct asset classes, the risk in the scheme is reduced.
  - It can be based on **(i)** Fixed Asset Allocation **(ii)** Flexible Asset Allocation
  - **Between fixed asset allocation funds and flexible asset allocation funds, the latter carry higher risk.**
- **Monthly Income Plan (MIP) :**
  - It seeks to combine a large debt portfolio with a yield-kicker in the form of an equity component.
  - In such a structure, it is possible that losses in the equity component eat into the profits in the debt component of the portfolio.
  - If the scheme has no profits to distribute, then no dividend will be declared.

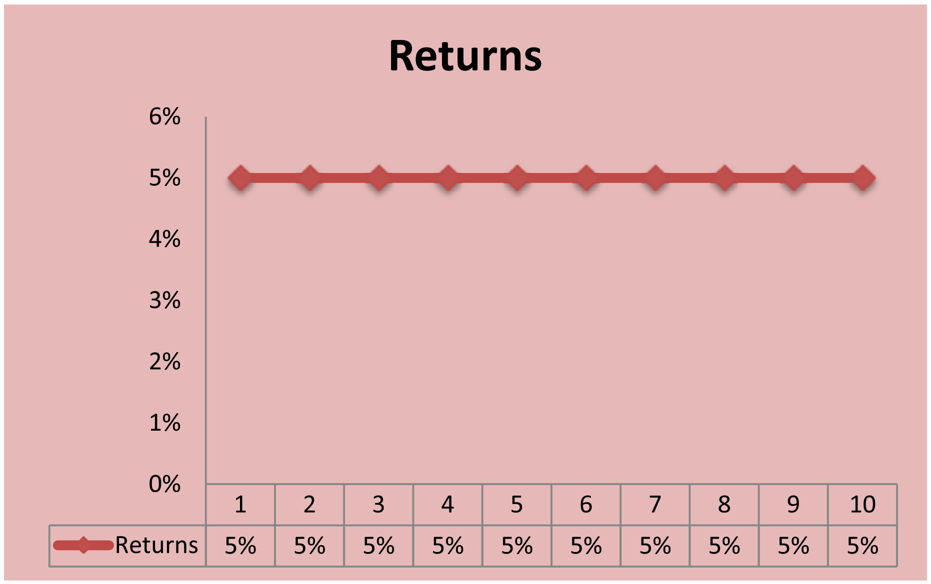
Risk In Gold Funds

- As an international commodity, gold prices are a lot more difficult to manipulate. Therefore, there is better pricing transparency.
- Further, gold does well when the other financial markets are in turmoil. Similarly, when a country goes into war, and its currency weakens, gold funds give excellent returns.
- These twin benefits make gold a very attractive risk proposition. An investor in a gold fund needs to be sure what kind of gold fund it is – Gold Sector Fund or ETF Gold.

Risk In Real Estate Funds

- Valuation of real estate assets is therefore highly subjective.
- **Problems :**
  - Black money
  - Less liquid asset class
  - Transaction costs
  - Regulatory risk
- **Benefits :**
  - Gives dual benefit : Exposure in Real Estate and Liquidity of MF
  - Real estate funds are quite high in risk, relative to other scheme types. Yet, they are less risk than direct investment in real estate.

Measures of Risk



	1	2	3	4	5	6	7	8	9	10
Returns	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%

No Risk

	1	2	3	4	5	6	7	8	9	10
Returns	5%	-10%	6%	-15%	20%	-2%	15%	-3%	10%	-1%

Risky

Measures of Risk

- Total Risk
  (Variance, Standard Deviation)
  - Systematic Risk
    (Beta - β)
  - Unsystematic Risk / Specific Risk

Beta - β

- Beta is a measure of Systematic Risk.
- Beta of any Index will always be 1.
- Beta for particular security or portfolio can be 1, More than 1 or Less than 1.
- Interpretation :
  - $\beta = 1$ --- Return of security / portfolio = Market Return
  - $\beta > 1$ --- Return of security / portfolio $>$ Market Return (Aggressive security / portfolio)
  - $\beta < 1$ --- Return of security / portfolio $<$ Market Return (Defensive security / portfolio)
- This is relevant to EQUITY only.

Measures of Risk & Benchmark

- Un-systematic risk / Specific Risk can be reduced through diversification.
- Performance of the scheme is compared with Benchmark.
  - It should be in synch with the investment objective of the scheme
  - The benchmark should be calculated by an independent agency in a transparent manner, and published regularly.
  - **In case of Index Funds, gaps between the scheme performance, and that of the benchmark, are called *Tracking Errors. Or***
  - **The difference between an index fund's return and the market return, as seen earlier, is the *Tracking Error*.**
  - Index fund with least Tracking Error is the best.
- Example of Benchmarks : **Equity:** S&P CNX Nifty, BSE Sensex **Debt:** Si-bex, Mi-Bex, Li – Bex **Gold:** Gold Price

End of the chapter…

CHAPTER 6

ACCOUNTING, VALUATION AND TAXATION

Net Asset Value

Particulars	Amount
Market value of investments Plus(+): Current assets and other assets Plus(+): Accrued income Less(-) : Current liabilities and other liabilities Less(-) : Accrued expensesDividend accrued but not received	---
Net Assets	**---**
(Divided by) Total number of Units Outstanding	---
Net Asset Value (NAV)	---

Net Assets of Scheme

- Net assets includes the amounts
  - Originally invested
  - The profits booked in the scheme and
  - Appreciation in the investment portfolio (Valuation Gains)
- **Net assets go up when the market prices of securities held in the portfolio go up, even if the investments have not been sold.**
- A scheme cannot show better profits by delaying payments.
- While calculating profits, all the expenses (Income) that relate to a period need to be considered, irrespective of whether or not the expense (income) has been paid (received).

Mark To Market

- The process of valuing each security in the investment portfolio of the scheme at its market value is called '*mark to market' i.e. marking the securities to their market value.*
- **Why?**
  - » If investments are not marked to market, then the investment portfolio will end up being valued at the cost at which each security was bought.
  - » When the NAV captures the movement, then only it is meaningful for the investors.
  - » Thus, marking to market helps investors buy and sell units of a scheme at fair prices.

Sale Price, Re-purchase Price & Loads

Sale Price	Mutual Fund Sells	Investor Purchases
Repurchase Price	Mutual Fund Repurchases	Investor Redeems

- **Loads**

Entry Load (1%)	NAV Rs. 10	NAV to Investor Rs. 10.10	No. Of units will be lesser
Exit Load (1%)	NAV Rs. 10	NAV to Investor Rs. 9.90	Amount credited in the bank account will be lesser

- **SEBI has banned entry loads w.e.f 1st August, 2009. So, the Sale Price needs to be the same as NAV.**
- Exit load structure needs to be the same for all unit-holders representing a portfolio.
- **Exit loads have to be credited back to the scheme immediately i.e. they are not available for the AMC to bear selling expenses.**

Transaction Charges

Types of Investor	Transaction Charges
First time mutual fund investor	**Rs. 100**
Investor other than first time mutual fund investor	**Rs. 150**

- **This can be charged**
  - One Time Investment
    - Investment amount ≥ Rs. 10,000/-
  - For SIP
    - (SIP Amount * No. Installment) ≥ Rs. 10,000/-
  - Incase of SIP, the Transaction Charge(s) will be deducted in four equal installments.
  - The transaction charge, if any, shall be deducted by the AMC from the subscription amount.

Transaction Charges

- **Transaction Charge(s) will not be deducted if :**
  - Purchase/Subscription submitted by investor at the designated collection centres or through AMC's website, Purchase/Subscriptions through any stock exchange i.e. transactions **which are not routed through any distributor.**
  - Purchase/ Subscription through a distributor for an amount less than Rs. 10,000.
  - Transactions such as Switches, STP where there is no additional cash flow.
  - If the distributor has taken 'OPT OUT' option.

Expenses

- **Initial Issue Expenses :**
  - **Not to be charged to scheme, it had to be born by AMC.**
- **Recurring Expenses : like**
  - Brokerage and transaction cost may be capitalized to the extent of 0.12% for cash market transactions and 0.05% for derivatives transactions respectively. More than this will come under the limit of TER.
  - Expenditure in excess of the prescribed total expense ratio limit (including brokerage and transaction cost, if any) shall be borne by the AMC or by the trustee or sponsors.

Service Tax

- Mutual funds /AMCs may charge service tax on investment and advisory fees to the scheme in addition to the maximum limit of total expense allowed for the scheme
- Service tax on expenses other than investment and advisory fees, if any, is to be borne by the scheme within the maximum limit of total expense allowed for the scheme.

Expenses Cannot Be Charged To The Scheme

- Penalties and fines for infraction of laws.
- Interest on delayed payment to the unit holders.
- Legal, marketing, publication and other general expenses not attributable to any scheme(s).
- Fund Accounting Fees.
- Expenses on investment management/general management.
- Expenses on general administration, corporate advertising and infrastructure costs.
- Depreciation on fixed assets and software development expenses.

Recurring Expense Limits

- Annual limits on recurring expenses (including management fees) **for schemes other than index schemes :**

Net Assets (In Crore)	Equity Scheme	Debt Scheme
Up to Rs 100 crore	**2.50%**	**2.25%**
Next Rs 300 crore	**2.25%**	**2.00%**
Next Rs 300 crore	**2.00%**	**1.75%**
Excess over Rs 700 crore	**1.75%**	**1.50%**

- **Within the above limits**, the investment management fees (charged by the AMC) cannot exceed:
  - » 1.25% on the first Rs100 crore of net assets of a scheme
  - » 1.00% on the balance net assets.

Recurring Expense Limits

- **Management fees cannot be charged by liquid schemes and other debt schemes on funds parked in short term deposits of commercial banks.**
- **The expense limits for index schemes (including Exchange Traded Funds) is as follows:**
  - Recurring expense limit (including management fees):1.50%
  - Management fees: 0.75%.
- In case of a **Fund of Funds** scheme, the total expenses of the scheme including weighted average of charges levied by the underlying schemes shall not exceed **2.50%** of the daily net assets of the scheme.

Recurring Expense Limits - Additional

- **If the new inflows from beyond top 15 cities are at least**
  - 30% of gross new inflows in the scheme
  - 15% of the average assets under management (year to date) of the scheme, whichever is higher
  - funds can charge additional expense of up to **30 basis points** on daily net assets of the scheme.
- **In case inflows from beyond top 15 cities is less than the higher of (a) or (b) above,** additional total expense on daily net assets of the scheme shall be charged as follows:

$$\frac{\text{Daily net assets X 30 basis points X New inflows from beyond top 15 cities}}{\text{365 X Higher of (a) or (b) above}}$$

- The additional TER on account of inflows from beyond top 15 cities so charged shall be **clawed back** in case the same is redeemed within a period of 1 year from the date of investment.

Dividends & Distributable Reserves

- Valuation gains in the scheme's portfolio may never get translated into real gains.
- SEBI guidelines stipulate that dividends can be paid out of **distributable reserves.**
  - » All the profits earned (based on accrual of income and expenses as detailed above) are treated as available for distribution.
  - » Valuation gains are ignored. But valuation losses need to be adjusted against the profits.
  - » That portion of sale price on new units, which is attributable to valuation gains, is not available as a distributable reserve.
- It means that **dividend is paid out of real profits, after providing for all possible losses.**

Key Accounting & Reporting Requirements

- Norms are prescribed on when interest, dividend, bonus issues, rights issues etc. should be reflected for in the accounts.
- **NAV for equity and balanced funds is to be calculated up to at least 2 decimal places.**
- **NAV is to be calculated up to 4 decimal places in the case of index funds, liquid funds and other debt funds.**
- Investors can hold their units even in a fraction of 1 unit. However, current stock exchange trading systems may restrict transacting on the exchange to whole units.

Valuation

- Wherever a security is traded in the market on the date of valuation, its **closing price** on that date is taken as the value of the security in the portfolio.
- Where **equity shares** of a company are not traded in the market on a day, or they are thinly traded, **a formula** based on
  - » Earnings per Share of the company
  - » Book Value and
  - » Valuation of similar shares is used for the valuation.
- **Debt securities** that are not traded on the valuation date are valued on the basis of the **yield matrix** prepared by an authorized valuation agency. It is based on
  - » Credit rating of the security and
  - » Maturity profile.
- Where an individual security that is not traded or thinly traded, represents more than 5% of the net assets of a scheme, **an independent valuer** has to be appointed.

Taxation

- The mutual fund trust is exempt from tax but the trustee company will however pay tax in the normal course on its profits.

Taxation

Security Transaction Tax (STT)

On Equity-oriented Schemes Of Mutual Funds	
On Purchase or Sale of equity shares in stock exchange	**0.1%**
On Sale of futures & options in stock exchange	**0.01%**

On Investors In Equity / Equity Oriented Schemes Of Mutual Fund	
On Purchase of the units in stock exchange	**NIL**
On sale of the units in stock exchange	**0.001%**
On re-purchase of units (by fund)	**0.001%**

*** STT is not applicable on transactions in debt or debt-oriented mutual fund (including liquid fund) units.**

Taxation

Dividend Distribution Tax (DDT)

Other than Equity Oriented Schemes (Payable by the scheme)	
Residential Individual / HUF / NRI	25%+ 10% Surcharge + 3% Cess
	= 28.325%
Others	30%+ 10% Surcharge + 3% Cess
	= 33.99%

Capital Gain Tax

Type of Scheme	STCG	LTCG
Equity and Equity Oriented Scheme*	15 %	NIL
Debt and Debt Oriented Scheme	As per marginal rate (i.e. as per the tax slab of the investor)	10% without indexation Or 20% with indexation, Whichever is less

- Where STT is not paid for Equity Schemes, the taxation is similar to debt-oriented schemes.
- Dividends in the hands of the investor is tax free.
- There is no TDS on the dividend distribution or re-purchase proceeds to resident investors.

Setting off Gains and Losses under Income Tax Act

- In the normal course, one would expect that a loss in one head of income can be adjusted ("set off") against gains in another head of income.
- **A few key provisions here are:**
  - Capital loss, short term or long term, cannot be set off against any other head of income (e.g. salaries)
  - Short term capital loss is to be set off against short term capital gain or long term capital gain
  - Long term capital loss can only be set off against long term capital gain
  - Since long term capital gains arising out of equity-oriented mutual fund units is exempt from tax, long term capital loss arising out of such transactions is not available for set off.

Wealth Tax

- **Investments in mutual fund units are exempt from Wealth Tax.**

End of the chapter…

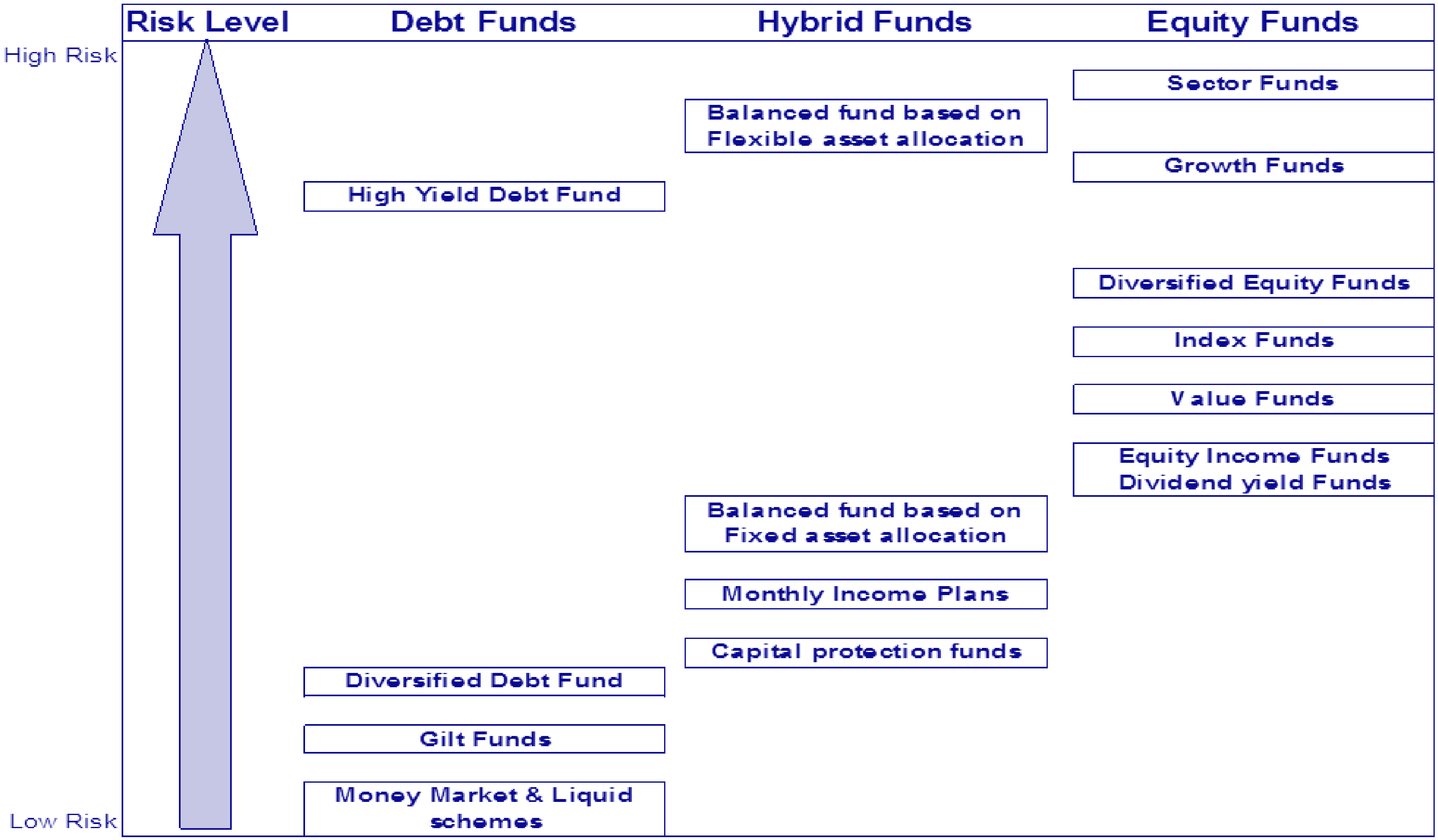
CHAPTER 9

SCHEME SELECTION

Basics

- The first step before advising a Financial Product is to understand the Risk appetite of the client. Recommendation should be based on various factors, amongst which Risk Appetite is most important.
- As a structured approach, the sequence of decision making is as follows:
  - » Step 1 – Deciding on the scheme category
  - » Step 2 – Selecting a scheme within the category
  - » Step 3 – Selecting the right option within the scheme

Scheme Risk Profile



Factors To Consider

Equity Funds :

- Active Or Passive Fund
- Open Ended Or Close Ended
- Diversified , Sector Or Thematic
- Large, Mid or Small Cap Funds
- Growth Or Value Funds
- Fund Size
- Portfolio Turnover
- Arbitrage Funds
- Domestic Or International

Debt Funds :

- Regular Debt Funds Or MIP
- Open Ended Or FMP
- Gilt Funds Or Diversified Debt Funds
- Long Term Or Short Term Debt Funds
- Money Market Or Liquid Funds
- Regular Debt Funds Or Floaters

Portfolio Turnover

- If the sale and purchase transactions amounted to Rs. 10,000 crore. The average size of net assets is Rs. 5,000 crore.
- Then the portfolio turnover ratio is

1. **Rs. 10,000 cr ÷ Rs. 5,000 cr = 2 Times or 200%.**

2. **This means that investments are held in the portfolio, on an average for 12 months ÷ 2 i.e. 6 months.**

Factors To Consider

- **Balance Funds :**
  - Investor can invest in a mix of equity schemes and debt schemes.

    Or
  - He can invest in a balanced scheme, which in turn invests in a mix of equity and debt securities.
- Investing in a balanced scheme makes things simpler for the investor.

- **Gold Funds :**
  - Gold ETF

    Or
  - Gold Sector Funds
- Difference is discussed in previous chapters.

Selecting Scheme Within A Category

- Parameters that are considered while selecting schemes with in a category are.
  - **Fund Age**
  - **Scheme Running Expenses**
  - **Tracking Error**
  - **Regular Income Yield**
  - **Risk, Return And Risk Adjusted Returns**
  - **Investor Objective**

Sources Of Data To Track Mutual Fund Performance

- Many AMCs, distribution houses and mutual fund research houses offer free tools in their website.
- The following are some of the agencies that are active in this field:
  - » Credence Analytics (www.credenceanalytics.com)
  - » CRISIL (www.crisil.com)
  - » Lipper (www.lipperweb.com)
  - » Morning Star (www.morningstar.com)
  - » Value Research (www.valueresearchonline.com)
  - » News Papers

End of the chapter...

CHAPTER 10

SELECTING THE RIGHT INVESTMENT PRODUCTS FOR INVESTORS

Physical or Financial

- Physical Assets include Gold, Land, Real Estate which one can touch and feel.
- Financial assets include Shares, Bonds, Mutual Funds, Fixed Deposit etc. They give ownership but can not be touched or felt.
- Physical assets can get destroyed or stolen. So, insurance is very important.

Implication

- **Comfort :**
  - The investor in a physical asset draws psychological comfort from the fact that the asset is in the investor's possession, or under the investor's control in a locker.
  - The value encashment in a financial asset, on the other hand, can depend on the investee company.
    - What if the company closes down?
    - What if the bank or mutual fund scheme goes bust?
    - These are issues, whether fact or myths, that bother investors.
  - Mutual fund schemes can offer a lot of comfort, in this regard.

Implication

- **Unforeseen Events :**
  - A physical asset may completely gone, or loses substantial value, when stolen, or if there is a fire, flood or such other hazard.
  - Theft or fire or flood, have no impact on the entitlement of the investor to a financial asset.
    - The investor can always go the investee organization i.e. company or bank or mutual fund where the money is invested, and claim the entitlement, based on records of the investee company and other documentary evidence.
  - Dematerialisation makes these processes a lot simpler.

Implication

- **Economic Context :**
  - » Investor's money in land, art, rare coins or gold does not benefit the economy.
  - » On the other hand, money invested in financial assets, e.g. equity shares, debentures, bank deposits can be productive for the economy.
  - » The money that the government mobilizes through issue of government securities can go towards various productive purposes.
  - » The company, whose shares are bought, can invest the money in a project, which can boost production, jobs and national income.
  - » The bank where the bank account or fixed deposit is maintained can lend the money to such productive activities, and thus help the economy.
  - » Similarly, mutual fund schemes that invest in securities issued by companies are effectively assisting in building the nation and the economy.
  - » This explains the interest of the government in converting more and more of the physical assets held by investors, into financial assets.

Gold – Physical or Financial

- **Options are…**
  - Physical Gold
  - Gold ETF
  - Gold Sector Fund
  - Gold futures contracts traded on commodity exchanges like the National Commodities Exchange (NCDEX) and Multi-Commodity Exchange (MCX).
- **Things To Consider**
  - Storage Cost
  - Insurance Cost
  - Transaction Cost
  - Capital Gain Tax
  - Wealth Tax

Real Estate – Physical or Financial

- **Real Estate in physical form is prone to a few more disadvantages:**
  - Ticket Size
  - No Diversification – Due to high ticket size
  - Risk Of Encroachment
  - Illiquidity
  - High Transaction Costs
  - Ownership Risk And Credit Risk – For let out property

Fixed Deposit or Debt Scheme

No.	Fixed Deposit	MF – Debt
1	Insurance Upto Rs. 1 lakh per depositor	No Insurance
2	No partial liquidity	Partial liquidity
3	None can earn returns higher than promised	Possibility to earn higher return, but can incur loss also
4	No tax deferment	Deferred Tax
5	No additional facility	STP, SWP

New Pension Scheme

- **Pension Funds Regulatory and Development Authority (PFRDA) is the regulator for the New Pension Scheme.**
- Two kinds of pension accounts are envisaged:
  - » **Tier I (Pension Account) :** is non-withdrawable.
  - » **Tier II (Savings Account) :** is withdrawable to meet financial contingencies. **An active Tier I account is a pre-requisite for opening a Tier II account.**
- Investors can invest through Points of Presence (POP)

New Pension Scheme

- Investment Choices :
  - **Asset Class E :** Investment in predominantly equity market instruments
  - **Asset Class C :** Investment in Debt securities other than Government Securities
  - **Asset Class G :** Investments in Government Securities
  - **Investors can also opt for life-cycle fund. The fund is managed based on the age amongst above mentioned asset classes.**

New Pension Scheme

- The 3 asset class options are managed by 6 Pension Fund Managers (PFMs).
- **Thus, 3 portfolios X 6 PFMs = 18 alternatives.**
- **These PFMs are authorised by PFRDA.** SEBI registered AMCs do not get automatic approval for management of NPS.
- **Investor in NPS is allotted a unique ID Number - Personal Retirement Account Number (PRAN).** This provides portability.
- POPs offer services related to moneys invested with any of the PFMs.

End of the chapter…

CHAPTER 11

HELPING INVESTORS WITH FINANCIAL PLANNING

Introduction to Financial Planning

- **What is Financial Planning?**
  - People experience happiness, when their needs and aspirations are realized within an identified time frame.
  - The estimated financial commitments towards future expenses become financial goals.
  - The financial goals must be defined in terms of time horizon and the amount of money required to fund the goal.
  - **Financial planning is a planned and systematic approach to provide for the financial goals that will help people realize their needs and aspirations, and be happy.**

Assessment of Financial Goals

- An estimate of these future expenses (the financial goals) requires the following inputs :
  - How much would be the expense, if it were incurred today?
  - How many years down the line, the expense will be incurred?
  - During this period, how much will the expense rise on account of inflation?
  - If any of these expenses are to be incurred in foreign currency, then how would changes in exchange rate affect the financial commitment?
  - This is done using the formula

$$A = P \times (1 + i)^n$$

A = Rupee requirement in future

P = Cost in today's terms

i = inflation

n = Number of years into the future, when the expense will be incurred.

Example

- Mr. A wants to plan for his child's education. Assuming that he wants his child to be a doctor. Let's assume that current expenditure of medical education is Rs. 15,00,000. His child is 3 years old and would require fees when he is 18 years. Find out the expenditure required at the child is 18 years old.
  - » P = 15,00,000
  - » N = 15 years (18 -3)
  - » I = 8% (It is inflation rate – Assumed)

A = 1500000*(1.08)^15 = Rs. 47,58,253

Investment Horizon

- Asset Allocation will be based on Time Horizon of Financial Goals.
  - Long Term Goals - Risky Assets (Like Equity)
  - Short Term Goals - Moderately Risky (Like Balanced Funds) or Low Risky Assets (Like Liquid Funds)

Assessing The Fund Requirement

- After finding out Future Value of Life Goal, we need to determine what amount should we invest today to reach that goals after pre – specified time.
- To do so…

$P = A \div (1 + r) ^ n$

A = Rupee requirement in future

P = Cost in today's terms

i = Expected Rate of Return from the asset class / Portfolio

n = Number of years into the future, when the expense will be incurred

- While the estimation of the goal value calls for an assumption regarding inflation, the amount required for investment also must consider the expected rate of return from the chosen investment.

Example

- Let's continue with same example. Now, Mr. A needs to accumulate Rs. 47,58,253 in 15 years. What amount should he deposit today to get the desired amount at the end of 15 years?
- As it is a long term goal, a person should invest in a riskier asset class. Let's assume that it is Equity and expected return from the same is 12%.

P = Rs. 1,00,000 / (1.12)^15 = Rs. 8,69,315

Financial Planning Objectives & Benefits

- **The objective of financial planning is to ensure that the right amount of money is available at the right time to meet the various financial goals of the investor.**
- **An objective of financial planning is also to let the investor know in advance, if some financial goal is not likely to be fulfilled.**
- The process of financial planning helps in understanding the investor better, and cementing the relationship with the investor's family. This becomes the basis for a long term relationship between the investor and the financial planner.

Need For Financial Planners

- The Financial Planner helps in
  - Performing Complex Financial Calculations
  - Understanding Complex Financial Products
  - Preparing Financial Plan and Implementing it tax-efficiently
  - Planning for Contingencies through advice on insurance products, inheritance issues etc…
- The Financial Planner thus is in a position to advise investors on all the financial aspects of their life.

Alternate Financial Planning Approaches

- Financial Plan can be
  - **Goal-oriented Financial Plan** – A financial plan for a specific goal
  - **Comprehensive Financial Plan** - Where all the financial goals of a person are taken together, and the investment strategies worked out on that basis.
- The steps in creating a comprehensive financial plan, as proposed by the Certified Financial Planner – Board of Standards (USA) are as follows:

1. **Establish and Define the Client-Planner Relationship**
2. **Gather Client Data, Define Client Goals**
3. **Analyse and Evaluate Client's Financial Status**
4. **Develop and Present Financial Planning Recommendations and / or Options**
5. **Implement the Financial Planning Recommendations**
6. **Monitor the Financial Planning Recommendations**

Life Cycle

» **Childhood :**

- During this stage, focus is on education in most cases. They are not earning members.
- Pocket money, cash gifts and scholarships are potential sources of income during this phase.

» **Young Unmarried :**

- The earning years start here.
- A few get on to high-paying salaries early in their career. Others toil their way upwards. Either way, the person needs to get into the habit of saving.
- This is the right age to start investing in equity.
- Personal plans on marriage, transportation and residence determine the liquidity needs.

Life Cycle

» **Young Married :**

- Where both spouses have decent jobs, life can be financially comfortable.
- Life Insurance is required, but not so critical. Where only one spouse is working, life insurance to provide for contingencies associated with the earning spouse are absolutely critical.
- Health insurance policy cover too should be planned. Starting a health insurance policy in earlier years is always better.
- Non Cashless policy increases the liquidity provisions that need to be made for contingencies.

Life Cycle

» **Married with Young Children :**

- Insurance needs – both life and health - increase with every child.
- Expenses for education right from pre-school to normal schooling to higher education is growing much faster than regular inflation. Adequate investments are required to cover this.

» **Married with Older Children :**

- The costs associated with helping the children settle i.e. cost of housing, marriage etc are shooting up.
- If investments in growth assets like shares and real estate, are started early in life, and maintained, it would help ensure that the children enjoy the same life style, when they set up their independent families.

Life Cycle

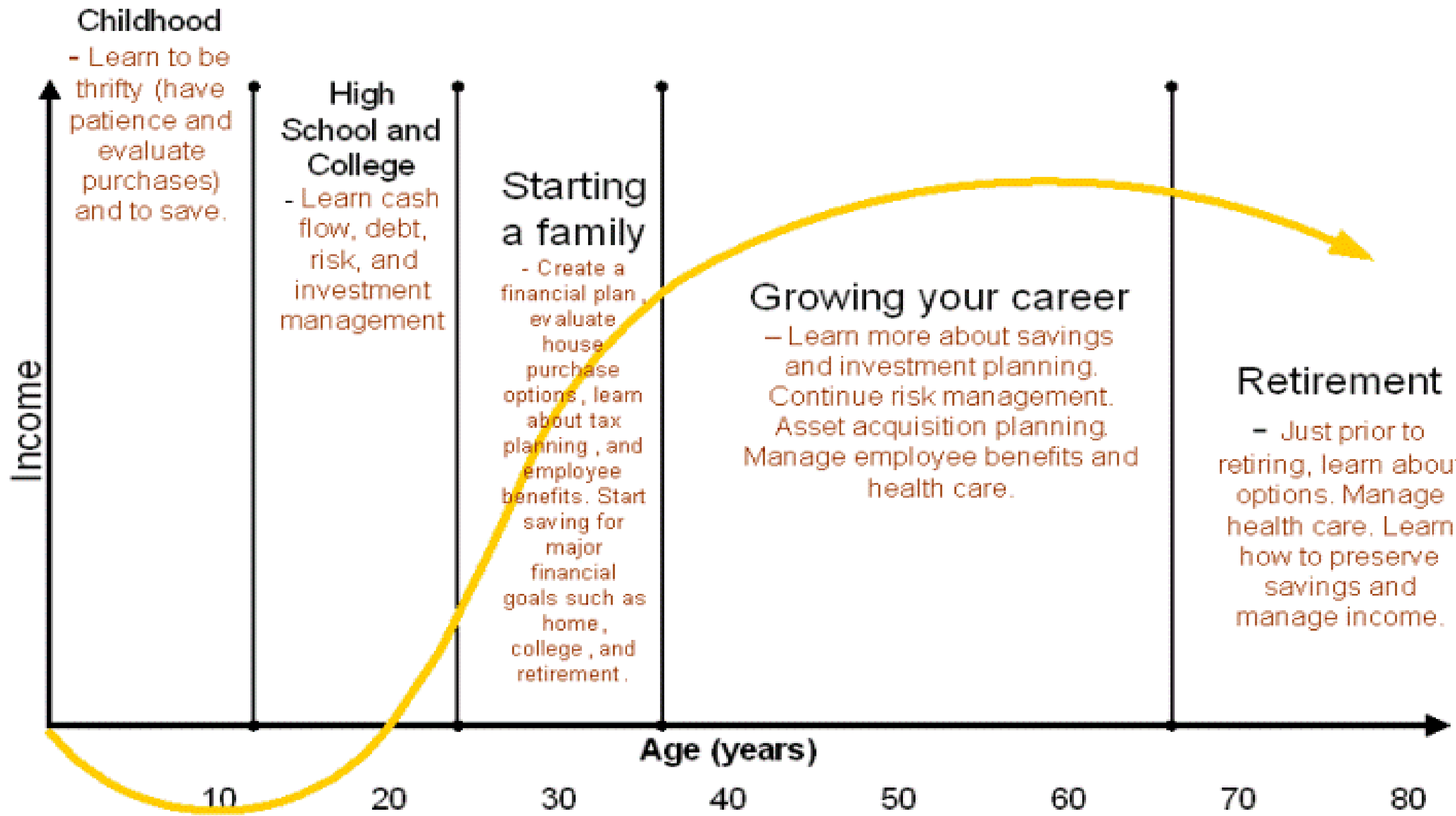
» **Pre-retirement :**

- By this stage, the children should have started earning and contributing to the family expenses.
- Further, any loans taken should have been extinguished.
- The family ought to plan for their retirement

» **Retirement :**

- At this stage, the family should have adequate corpus, the interest on which should help meet regular expenses.
- The need to dip into capital should come up only for contingencies – not to meet regular expenses.
- The availability of any pension income and its coverage will determine the corpus requirement.

Life Cycle & Wealth Cycle



Life Cycle & Wealth Cycle

Wealth Cycle	Life Cycle	Objective
Accumulation	Young Unmarried to Pre-Retirement	The investor builds his wealth
Transition	When financial goals are in the horizon	Given the impending requirement of funds, investors tend to increase the proportion of their portfolio in liquid assets
Inter-Generational Transfer	• It is never too early to plan for all this. • It should ideally not be postponed beyond the age of 50.	The investor starts thinking about orderly transfer of wealth to the next generation, in the event of death
Reaping / Distribution	Parallel of retirement phase in the Life Cycle.	This is the stage when the investor needs regular money.
Sudden Wealth	Any Time	• It is advisable to initially block the money by investing in a liquid scheme. • An STP from the liquid schemes into equity schemes will help the long term wealth creation.

End of the chapter...

CHAPTER 12

RECOMMENDING MODEL PORTFOLIOS AND FINANCIAL PLANS

Need For Risk Profiling

- There are differences between investors with respect to the levels of risk they are comfortable with (***Risk Appetite***).
- At times there are also differences between the level of risk the investors think they are comfortable with, and the level of risk they ought to be comfortable with.
- Risk profiling is an approach to understand the risk appetite of investors - an essential pre-requisite to advise investors on their investments.
- The investment advice is dependent on understanding both aspects of risk:
  - » Risk appetite of the investor.
  - » Risk level of the investment options being considered.

Factors That Influence The Investor's Risk Profile

Factors	Influence on risk Appetite
Family Information	
Earning Member	Risk appetite increases as the number of earning members increases
Dependent Member	Risk appetite increases as the number of earning members increases
Life Expectancy	Risk appetite is higher when life expectancy is longer.
Personal Information	
Age	Lower the age higher the risk that can be taken
Employability	Well qualified and multiskilled professionals can afford to take more risk
Nature of job	Those with steady jobs are better positioned to take risk
Psyche	Daring and adventurous people are better positioned mentally to accept the downside that come with risk.
Financial Information	
Capital Base	Higher the capital base better the ability to financially take the downside that come with risk
Regularity of income	People earning regular income can take more risk then those with unpredictable income streams

Risk Profiling Tools

- Risk profiling is a tool that can help the investor; it loses meaning if the investor is not truthful in his answers.
- Some AMCs and securities research houses provide risk profiling tools in their website.
- Some banks and other distributors have proprietary risk profilers.
- **These typically revolve around investors answering a few questions**, based on which the risk appetite score gets generated.
- Some advanced risk profilers are built on the responses to different scenarios that are presented before the investor.
- Service providers can assess risk profile based on actual transaction record of their regular clients.
- The financial planner needs to use them judiciously.

Asset Allocation

- 'Don't Put All Your Eggs In One Basket'. The distribution of an investor's portfolio between different asset classes is called **Asset Allocation.**
- With a prudent asset allocation, the investor does not end up in the unfortunate situation of having all the investments in an asset class that performs poorly. **Thus, the purpose of asset allocation is not to enhance returns, but to Reduce The Risk.**

Asset Allocation Types

- **Strategic Asset Allocation**
  - » is what comes out of the risk profile of the individual.
  - » The most simplistic risk profiling thumb rule is **100 – Age = Equity Portion.**
  - » It is advisable for the investor.
- **Tactical Asset Allocation**
  - » It is the decision that comes out of calls on the likely **behaviour of the market.**
  - » Tactical asset allocation is suitable only for seasoned investors operating with large investible surpluses. It is temporary. After taking advantage of market behaviour, one should turn back to Strategic Asset Allocation.
  - » **The last step in the process of portfolio construction would be selection of schemes within the agreed asset allocation.**

Model Portfolios

- Since investors' risk appetites vary, a single portfolio cannot be suggested for all.
- **Financial planners often work with model portfolios** – the asset allocation mix that is most appropriate for different risk appetite levels.
- **Financial Planner should have a model portfolio for every distinct client profile. This is then tweaked around based on specific investor information.**

Model Portfolios

Investor	Diversified Index Scheme	Diversified Equity Schemes	Sector Funds	Gold ETF	Gilt Fund	Diversified Debt Fund	Liquid Schemes
Young call centre / BPO employee with no dependents	0	50%	20%	10%	0	10%	10%
Young married single income family with two school going kids	0	35%	10%	15%	0	30%	10%
Single income family with grown up children who are yet to settle down	0	35%	0%	15%	15%	15%	20%
Couple in their seventies, with no immediate family support	15%	0	0	10%	30%	30%	15%

Best of luck . . .